THE FUTURE OF MONETARY POLICY

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A Report on
International Monetary Problems
by a Group of the Royal
Institute of International
Affairs

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FIRST REPORT

On international monetary problems by a Study Group of members of the Royal Institute of International Affairs

MONETARY POLICY AND THE DEPRESSION

1956

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'Considering the complexity of the problems involved, the writers of the Report must be congratulated on the skill with which they have managed to assemble the salient points as far as both the description of the position and the analysis of the different views is concerned.' *The Economist.*

'A worthy successor to *The International Gold Problems* and *World Agriculture*. . . . The Report deserves attention as an instance of the new technique which is being evolved in Chatham House. . . . In six chapters the various views which are entertained as to the part which money has played in engendering and prolonging depression, and the part which it may play in stimulating a return to prosperity, are set out with a clarity which should bring many vexed questions within the general comprehension of any intelligent reader.' *The Spectator.*

'. . . makes a notable contribution to the cause of clear thinking on international monetary problems. . . . Everybody who thinks about economics will be grateful for this clear, well-written and dispassionate statement of the monetary problem.' *Statist.*

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PRINTED IN GREAT BRITAIN

FOREWORD

The Study Groups Department of the Royal Institute of International Affairs was set up in 1931 to organize collective research into current problems in the international field. The membership of the Institute includes many authorities with valuable experience acquired in dealing with such questions of the day, and it was felt by the Council of the Institute that if these authorities could be persuaded to meet and discuss and set out their views, any resulting publication would help to build up an informed public opinion both at home and abroad. Thus it was hoped to produce a series of objectively written studies which would appeal not only to experts but also to the wider public of those interested in world affairs. With this aim in mind, several volumes have already been published and other investigations are in progress.

The present Report is the Final Report of the Study Group on International Monetary Problems, which was responsible for *Monetary Policy and the Depression*, published in May, 1933. The membership of the Group to whom the Council are indebted for its preparation is:

Sir Charles Addis (*Chairman*).
Mr. C. I. C. Bosanquet.
Mr. R. G. Glenday.
Mr. N. F. Hall.
Mr. R. F. Harrod.
Mr. H. D. Henderson.
Major the Rt. Hon. J. W. Hills, M.P.
Mr. O. R. Hobson.
Mr. Jules Menken.
Mr. F. W. Pethick-Lawrence.
Mr. D. H. Robertson.
Commander Stephen King-Hall (*Secretary, Study Groups Dept.*).
Mr. A. T. K. Grant (*Group Secretary*).

The Group is indebted to Professor Lionel Robbins, who took part in a large number of its discussions but is unable to accept the general standpoint of the Report.

In addition the Council acknowledges the help it has received from many other authorities who have placed their knowledge and experience at the disposal of the Group.

In reading this Report it should be borne in mind that, as is customary in the Study Group work of Chatham House, the members of the Group invited by the Council to investigate and report on a specific subject do so on the understanding that, though they accept responsibility for the work as a whole as being a useful contribution to the literature on the subject, they do not necessarily subscribe

individually to every statement in the book. The Group wish to add, as to Part One of the Report, that while they have aimed at an agreed statement they have not hesitated to call attention to differences of opinion within the Group where the divergence seemed of sufficient importance. In this connexion the qualifications by Sir Charles Addis, Mr. N. F. Hall, and Mr. O. R. Hobson (pp. 24–7) and by Mr. R. G. Glenday (p. 11) and supplementary notes by Mr. R. F. Harrod (p. 13 and p. 15) should be noted.

The Group has expressed to the Council their high appreciation of the continued services of Mr. A. T. K. Grant as Group Secretary and of his work in drafting this Report.

NEILL MALCOLM
Chairman of the Council,
Royal Institute of International Affairs.

CHATHAM HOUSE,
10, ST. JAMES'S SQUARE,
LONDON, S.W.1.

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PART THREE

MONETARY POLICY IN THE INTERNATIONAL SPHERE

CHAPTER I

INTRODUCTION

THE monetary problem first sprang into general prominence after the War, when statesmen in all countries were faced with the task of reconstructing a broken international monetary system. Two international conferences[1] vigorously affirmed the importance of this task, while inflation in Germany and elsewhere seemed to point the moral. In due course the return of Great Britain to the gold standard was hailed as giving a lead in the great work of reconstruction, and in their turn other countries followed suit.

The restoration of the gold standard represented only the beginning of the attempt to deal with the monetary problem. Heavy totals of unemployment provided a reminder that in this country the task of reconstruction had to be carried very much farther. At Geneva the question of trying to eliminate undesirable fluctuations in the purchasing power of gold was agitating the minds of statesmen and of financial experts; fear of a gold shortage and deflation on that account led to the appointment of the Gold Delegation of the Financial Committee of the League of Nations. But events moved so fast that the beginning of the work of this Delegation coincided with the beginning of the world depression, and its final Report appeared when the slump was at its worst and when for many countries the problem of gold had become, for the time being at any rate, an academic question. Other developments proved equally abortive: the Young Plan soon showed itself the prelude, not to a new prosperity, but to the Hoover moratorium.

In the meantime the Report of the Macmillan Committee had appeared in Great Britain, and within a few months the main assumption on which it had been based—that this country would remain on the gold standard—had ceased to be true. Britain's example in going off gold was followed by other countries, including in due course the United States. The international standard which had been rebuilt so laboriously from 1922 onwards had again collapsed, and the World Economic Conference in London in 1933 failed to do anything to restore the position.

Behind this impressive façade of happenings there has grown up a general and widespread distrust of the way in which questions of monetary policy have been handled. The criticisms that have been

[1] Brussels, 1920; Genoa, 1922.

advanced vary greatly and are not necessarily all justified; but it is an undoubted and impressive fact that they exist. The public will not to-day accept blindly a scheme devised by experts *in camera.* It is essential that any policies pursued shall command the sympathy and compliance of the multitudes whom they will ultimately affect. Hence the importance of thorough and disinterested inquiry.

It is clear that the monetary problem has so many ramifications, and touches on so many other outstanding questions, that it cannot be solved easily or quickly. The difficulties to which it gives rise are of every sort: difficulties of technique, of social policy, and even of moral outlook. They are not confined to the national and international political questions of the moment, to a lack of knowledge where economic considerations are concerned, and to the impossibility of making any far-reaching experiment where human welfare may be involved—for political and economic scientists are both under this handicap, that they can never be allowed to experiment freely since the material of their experiment must be society itself. Far wider considerations are involved, extending beyond politics and economics.

The approach must differ according to how world events shape themselves. Stability and progress are, in a limited sense, complementary, but under certain conditions they may become alternatives. Is rapid development, with its booms and depressions, its alternations of feverish well-being and blank misery for the masses, to be preferred to a much slower development which yields security in place of transient patches of luxurious plenty? To put a connected, but slightly different question, which must largely be answered in the light of events and probabilities, are we to look to a world in which 'international specialization' and the exchange of goods and services between countries is the dominating feature, or to a world of planned national units aiming at security and stability because the force of free development is too fast and the future too uncertain? Or, to what extent will there be a combination of the two? These questions, again, cannot be answered here; but it must not be forgotten that any attempt to see a way through the monetary problem must be applicable to a world in which such questions are dominant. And it is well to emphasize at the outset that the world's estimate of these tendencies—whether we are likely to move towards a greater subdivision into economic units, or towards a greater internationalism—must influence the shape which the monetary systems of the future will take.

The monetary problem cannot be isolated and considered apart from other more general economic activities. It is quite impossible

to draw a hard-and-fast line between things monetary and non-monetary, or to uphold the view that a redrafting of banking and currency legislation, combined with a broader outlook on the part of those in control of financial institutions, would alone be enough to restore and maintain an age of plenty. Account must be taken of far wider political questions. Some of these lie entirely outside the scope of this inquiry. Others which properly enter into it include, for example, the taxation and expenditure policy of the State. Since this means that we are concerned not merely with how money is provided but how money is spent, it is clear that the possibility of a clear-cut line of demarcation around things monetary vanishes completely.[1] The most that one can say is that the word 'monetary' provides an approach; it cannot delimit a 'monetary' problem from a general economic problem.

The monetary problem—that of providing and working a thoroughly satisfactory currency and credit machine—cannot, therefore, be solved easily or finally before a distant future. But this does not imply that the advantages or disadvantages which follow on particular decisions are of little immediate significance. At any given moment the Central Bank of each country is deciding whether to maintain or to change the terms on which it is prepared to grant credit; exchange control authorities have to take action day by day and hour by hour; banking leaders and Treasury officials are constantly in touch with each other to consider the questions that arise. It is necessary for authorities such as these to make decisions, and even if they be negative and in favour of maintaining things as they are, positive results are constantly ensuing. These decisions affect—at greater or less remove—the economic system in which people both produce and consume the things of which they are in need. A change in the cost of credit may make new developments possible or impossible; a change in an exchange rate may make certain business profitable for one country and unprofitable for another. Credit expansion at one moment may mean apparent extra prosperity at the expense of a disastrous future; credit contraction may create or prolong a slump. Profits, prices, wages, incomes, debts are constantly being affected. Some burdens increase; others become lighter. Some industries will gain while others will lose. The livelihood of millions is at stake. There is no escaping the monetary problem on the ground that its final solution must be remote.

[1] Hence in the following pages 'monetary policy' will be used in its widest sense; and—as far as possible—'banking', 'currency', 'credit', or 'fiscal' policy where narrower and more specific meanings are required.

In their First Report[1] the Group on International Monetary Problems attempted to provide an introduction to the subject by setting out certain aspects of depression, explaining and criticizing the chief differences of approach and opinion among experts, and linking the argument to the world situation as it was at the time. Such a foundation was necessary to any further analysis and to any clearly defined conclusions. It deliberately stopped short of suggesting—or even of examining at any length—lines on which advance might come. It was intended, as was foreshadowed in its pages, to be the precursor of the present study, which is designed to view international monetary problems at greater length and from a wider angle. Further, as was also foreshadowed, members are now prepared to indicate in what directions their own conclusions lie, and not merely to compare and assess the opinions of others.

Accordingly the Group begin the present study by setting out at some length their conclusions as to policy. In the two chapters on 'Ultimate Objectives' and 'Short-Term Policy' they attempt to show not only the ground which they have in common, but also the differences of opinion which divide them on certain material points. Having thus set out their views, the Group proceed to a more detailed examination of all that is involved in the monetary problem. In the second part of the book the relationship of a monetary system to economic activity is analysed and discussed; in the third part the interrelationship of monetary systems in the world. Broadly speaking, the effect of this arrangement is to set out the views of the Group on questions of policy, and then to consider monetary systems, first, as preservers of internal economic stability, and, second, as preservers of stability in international transactions.

Thus the second part opens with a general discussion of certain economic fundamentals and goes on more specifically to examine the reaction between monetary policy and the general pace of economic activity. This is followed by an examination of the specific weapons at the disposal of the financial authorities and—going farther afield—of the significance of the fiscal policy of Governments. The section ends with an examination of the special problems of Great Britain.

The third part aims at bringing these considerations into relation with the international problem. It begins with an examination of the significance of an international monetary standard and the working of the gold standard, and goes on to explain exchange rates and the

[1] *Monetary Policy and the Depression*, the first report of the Group, published in 1933 by the Oxford University Press, under the auspices of the Royal Institute of International Affairs.

interaction of monetary systems. Short-time balances and the provision of long-term capital are discussed in some detail, both in themselves and in relation to the needs of certain types of borrowers. A chapter is devoted to the part that might be played by special international machinery (perhaps based on the Bank for International Settlements) in solving certain outstanding difficulties, and an attempt is made to assess the position of gold as a currency base. The book ends with a discussion of certain problems of monetary reconstruction.

PART ONE

PROBLEMS OF POLICY

CHAPTER II

ULTIMATE OBJECTIVES

THE question of ultimate objectives is fundamental to the monetary problem. Such objectives must not only appear desirable in the light of theoretical possibilities and attributes, but also must be sufficiently attainable to bring them into the realm of practical politics. Before going on to consider what type of international system (or set of relations governing the different national systems) may be held to provide a reasonable objective for the world, it may be well to stress six preliminary considerations which are taken as fundamental by the Group.

First, international co-operation is in principle desirable even though many would hold that in practice there is at the moment little possibility of any really far-reaching steps in this direction in the early future. It must not be forgotten that specialization on a world basis in accordance with natural advantage has provided in the past the foundation for the increase in humanity's real wealth. It is to be hoped that a moment may come when it will be possible to achieve some sort of international understanding, even though it fall short of a uniform international standard.

Secondly, the monetary system must provide the basis of continuity of values.[1] Such continuity has been woefully absent in every country during the last twenty years. The general price level has changed so greatly both up and down that contracts made in terms of money have completely failed to implement the intentions of the contracting parties. Huge adventitious profits and terrible unmerited losses have been made owing to monetary appreciations and depreciations in the value of the same physical quanta. Prices and costs have failed to keep pace with one another. Prices of foods and raw materials have moved faster than prices of finished products. The symptoms associated with the words 'boom' and 'slump' have been exhibited to an unprecedentedly striking degree. The Group is of opinion that monetary policy must be directed to preventing, in so far as is possible, a repetition of such discontinuity of values in the future.

Thirdly, continuity of values and exchange stability are not absolute alternatives, since the one is not fully attainable without a substantial measure of the other. Continuity of values carries the implication that general price movements, if any, should not exceed

[1] For an analysis of the conception, 'continuity of values', see below, pp. 10–15.

movements in the general level of costs resulting from technical changes. For any country doing a large export and import trade it is quite clear that prices and costs will be strongly affected by exchange movements, and not merely by what happens within the national boundaries. For such a country any attempt to estimate either prices or costs (and it is upon estimates that business decisions ultimately depend) requires as a basis a reasonable assurance as regards the terms on which one currency exchanges for another. Equally if an attempt be made to secure exchange stability without a substantial measure of continuity of values, a break-down similar to that of recent years is certain to occur again.

Fourthly, management is inevitable. The mere existence of credit involves management through control of the terms on which it is granted. Arguments about automatic as against managed currencies are beside the point. It is true that in the past, and even at present, countries find certain policies more or less imposed on them from outside because of their dependence on outside financing, and to this extent their reactions are automatic, but always in the world among the leading centres there have been one or more whose policy, looked at from the standpoint of their external relationships, has been more or less unfettered in its choice. If it be held against certain countries that they should not have offset losses of gold, that is not to argue that the reaction should have been more automatic but that the particular management was mistaken.

Fifthly, the tools of management include, among others, manipulation of the discount rate, open market operations to enlarge or contract the basis of credit, and Government financial policy, shown in the taxes it imposes, in the amounts it sets aside for debt redemption, and in its outlay on capital works. The use of these tools may not give authorities complete control over the pace of economic activity, but used with skill and at appropriate moments should enable monetary policy to play its part in preventing either excessive expansion or excessive contraction.

Sixthly, given the existing state of public opinion, especially abroad, the use of gold will probably make it easier to secure stability of exchange with other nations, though in theory such stability could just as well be secured without gold. On the other hand, gold in itself cannot help in the task of maintaining a continuity of values.

1. *Continuity of Values*

While the Group agree as to the vital importance of preserving continuity of values, their views are not coincident as to the precise

criteria by which it should be tested.[1] It is easy to recognize its absence during the last twenty years, but it is less easy to specify the condition or conditions which will prove its presence in the future, for it is obviously not sufficient to provide a negative definition like that of salt by the small boy who said it was 'that which made potatoes so nasty when it wasn't used in cooking them'. Some members of the Group place the main emphasis on preserving stability in the level of wholesale prices, and are of opinion that if this were definitely secured other aspects of the problem, in so far as they are monetary, would largely resolve themselves. The majority regard this single criterion as too narrow and would expand their interpretation on the following lines.

Starting from the conception of 'continuity of values' as conveying the idea that general price movements, if any, should not exceed movements in the general level of costs resulting from technical changes, they hold that in the past movements of price indices have rather been over-emphasized. While these are important, they should be interpreted in the light of the history of their main constituents, since the particular index may be influenced by extraneous factors working on the prices of particular commodities and not by general movements affecting prices as a whole. Further, quantities must be taken into account. The fact that pools may be formed to support the prices of particular commodities, or that valorization schemes may be breaking down, may not be relevant to monetary policy though it almost certainly will influence indices of prices. In short, price indices are important, but must be interpreted critically.

Nor should attention be confined to comprehensive indices of prices alone. Comparison between indices of different prices should be instructive—in particular, movements in the prices of producers' goods as compared with consumers' goods, allowing in both cases for any technical changes in the circumstances of supply.

[1] 'I disagree fundamentally with the concept of "continuity of values" (see especially p. 60) and consequently with the "ultimate objectives" based on it. To use that concept as a basis on which to construct a long range investment policy for the future cannot, I believe, fail to ensure a repetition of the present disaster. Except during relatively short periods, economic progress is a *discontinuous* process. In any case, since economic growth is subject to the operation of the law of diminishing returns, it would be a mistake to stabilize the profit margin. The problem of stability is to equate the rate of growth of production to the rate of growth of consumption, and vice versa. It was not the break in the continuity of foreign investment (vide p. 25) in the immediate pre-slump years which brought the present collapse, but that much of the lending that *did* occur was based on a complete misreading of the potentialities for accelerating consumption in various directions under the limitations of the congested and abnormal environment of the post-war world.'—R. G. Glenday.

Nor can costs be ignored. Any indices which bear on wages or increasing productivity are significant, as well as any figures showing the changes in the profits being earned by entrepreneurs. If one of the broad problems (and it is only one) is that of whether there is too much money or too little, figures of prices, costs, and profits at least help to show a whole set of factors to be taken into account.

But such figures on the whole are limited in their application to future policy. They are valid in so far as they show the position existing in the present or—more probably—in the immediate past; they do not throw any certain light on future expectations, and it is important to remember that if disproportions arise in the economic system they will have had their origin in mistaken expectations as regards the future. For this reason the prices of securities on security markets and the volume of new issues being brought forward are of a very real significance. They reflect not merely new investment but also the importance which people are attaching to the prospects of new investment. If the outlook is over-estimated, failures are bound to result and to depress activity at some future date. Mistaken valuations can in the long run only make for depression, since the readjustments involved may be difficult if they have tended to affect industry as a whole.

There are other sources of information which monetary authorities would have to take into account; in particular, figures of employment, of foreign trade, and any information bearing on the development of particular industries of importance. Admittedly it is not an easy task to decide in what phase of activity in relation to normal a country may be—whether conditions are depressed or prosperous, whether boom is approaching or not, whether the bottom of the slump has been reached. Yet such decisions have been made and can be made with reasonable assurance, and could be made with greater exactness if the fund of available economic information were to be greatly increased.

The Group are agreed that whether the criteria for continuity of values be on the narrower or the wider basis, its attainment must be the subject of technical exploration and day to day experiment. But though the knowledge which we have is more limited than we should like, the Group have no doubt that the knowledge available could do much to enable monetary authorities to relate economic activity to a healthy norm, and to prevent the extremes of expansion and contraction which have been characteristic of the past.

It is here that the various weapons at the disposal of monetary authorities come into play. The checking of booms[1] by higher dis-

[1] A boom does not of course arise when there is genuine and continued

count rates and tighter money will be needed at certain points in the business cycle. During depression central banking operations may be supported, when circumstances require, by an increased flow of government expenditure on public works, and appropriate changes in the policy governing public finance. That sinking fund contributions should be increased in prosperity and reduced during slump is now fairly generally accepted. Budget deficits during depression are usually a matter of necessity rather than choice; that they should be a matter of choice may be admitted in theory, but the difficulty is that of securing an informed public opinion which will support adequate surpluses during prosperity.[1] In addition to these recognized methods of giving a stimulus to economic activity or of preventing it going to artificial lengths certain other methods of minor importance might be employed; for example, some qualitative control over the direction in which money is being invested; publicity designed to make clear reasons for certain courses of action; agreement to vary the proportions in which different types of asset are held by the banking system. During prosperity the banking system should aim at preserving a high proportion of liquid assets, while during depression it should be able to hold less liquid assets since liquid assets will be in special demand elsewhere.

But it must not be supposed that an aggregation of individual national policies, all aiming at preserving an internal continuity of values, can ever be successful in preserving continuity of values in the world as a whole unless further steps are taken. In many ways it is fair to say that one of the major deflationary influences in the world at large is the spasmodic nature of international lending. These fluctuations in international financial relationships have unfortunate results. Debtor countries, having adapted themselves to a process of development based on the import of capital, suddenly find their supplies cut off. Creditor countries, suddenly unwilling to lend, find themselves with favourable balances which they may take in gold or

expansion of economic activity, but when there is an expansion of such activity artificially fostered through a plethora of money and involving, or likely to involve, a break-down in continuity of values.

[1] 'I regard it as imperative that immediate steps should be taken to build up an informed public opinion in this matter. A Reflation Fund should be instituted at once with powers to borrow at least as great as those of the Exchange Equalization Fund, primarily with a view to use at the onset of the next depression. At an early stage in it, i.e. at the first onset of what is called in this Report "the secondary depression" (see p. 50), the Chancellor of the Exchequer would announce that he was drawing, say, £300 million from the Reflation Fund towards current expenditure, and remit taxation accordingly.' —R. F. Harrod.

foreign exchange. The debtor country has to try and adapt itself suddenly to a new life in which foreign lending plays no part. The creditor finds her industries stagnant where they are involved in the export of capital goods. No amount of internal manipulation can eliminate the disturbance due to the cessation of the lending flow. If an international continuity of values is to be preserved this involves, not a large but a steady amount of international lending. Without this any international system is doomed to have sudden strains and stresses put upon it.

The real problem is illustrated by the position of France in the years immediately before 1931. France was a creditor on international account, but she failed to invest her surplus abroad and so drew gold and put a strain on the other national economies. Problems of this sort are constantly tending to arise, and it is on their solution that the successful working of any international system must depend. Broadly speaking, it may be suggested that responsibility for the balance of payments must be newly and clearly defined as a prelude to any workable system. If world prices are, or are becoming, too low, the responsibility for righting the balance should be on the countries with favourable balances only. If a country finds that gold is flowing in, and if this inflow is not due to movements of alarmed short-term money, that country should adopt a strongly expansionary policy, using all the tools of management for that purpose. If she does this sufficiently vigorously, in time she will stimulate foreign lending and increase purchases until the balance rights itself.

The problem of foreign lending is especially important since, as we have seen, it is through the break-down of the normal lending process that the world finds itself divided into two camps: countries with favourable balances which they cannot employ, and countries with unfavourable ones which they do not know how to reduce. Progress will inevitably be slow as long as the political background is so uncertain. But machinery for international long-term lending might be improved through the development of institutions similar to the proposed International Agricultural Mortgage Company.[1] Special arrangements might be made in case of emergency to strengthen the hands of the B.I.S. in supporting countries in temporary financial difficulties. In any case the assets of the B.I.S. are ridiculously low, and if it is to play any part in making international payments easier they will have to be enlarged. The problem of a country with successive heavy surpluses on the balance of payments might be dealt with by an agreement that such surpluses should be taken in the

[1] See below, p. 193.

form of deposits with the B.I.S., these deposits only bearing interest at a very low or a nominal rate. All these considerations must—as the world is at present—seem somewhat remote; but the important thing is that it should be recognized that a country which proceeds to accumulate a favourable balance without investing it, and goes on doing so, is behaving in an anti-social manner which in the long run may prove fatal to any international system.

There is one further problem to be considered, that of the currency base. Whether this base be metallic or not, no essential difficulty is involved. For example, the effectiveness of a given supply of monetary gold could easily be increased or decreased through an agreed policy between the three or four leading financial centres working through some such institution as the B.I.S. If balances with such an institution are allowed to reckon for reserve purposes, there is an opportunity for credit expansion or contraction. The matter rests in the hands of the leading Central Banks; there is no technical difficulty which would prevent them from working in harmony to offset an excessive increase in the world's effective gold supply, or to increase the effectiveness of the supply when it falls too low. But it is quite clear that the initiative must lie with the leading Central Banks, and not with the B.I.S., which at most will be a convenient instrument to hand.

The Group therefore concludes that the problem of preserving continuity of values is a double one. On the one hand, monetary authorities must aim at preserving balanced conditions in economic activity at home; on the other, they must aim at building a stability of international relationships and a machinery (the nucleus for which may be found in the B.I.S.) which will enable the leading financial centres to work together in easing payments, providing support in time of emergency, and increasing or decreasing the supply of credit the world over as conditions may dictate.[1]

2. *Stability of Exchange*

It is quite clear that under fair-weather conditions exchanges stabilized at an appropriate level, possibly subject to periodic revision,

[1] 'I regard maintenance of continuity in the value of money to be so vital for the preservation of our economic life and, indeed, of civilization, and so difficult to achieve in practice, that it should be regarded a matter of national urgency. An Official Advisory Board should be at once set up, and instructed to mature plans for securing continuity. It should be in close touch with the Cabinet. It should also establish contacts with the leaders of finance, to ensure that when the situation demands drastic action—as it is bound to, if the objective is to be achieved—the effectiveness of that action be not impeded by any lack of confidence or understanding on the part of the public.'—R. F. Harrod.

are eminently desirable. Their desirability becomes a matter of doubt when conditions are disturbed and in a state of upheaval. The conception of an exchange stability implies a freely functioning exchange. A fixed exchange maintained through 'blocked balances' and devices of that sort has no merits; it is damaging to trade, to estimates, and to expectations alike.

The present fear of fixed exchanges is partly due to the misfortunes of the post-War years, and partly to the fact that the exchange parities which emerged were so unbalanced that they introduced into international economic relationships as many elements of strain as they removed. On the assumption that in the future any fixed exchange parities which emerge are likely to be much more reasonable than those that were experienced in the years before 1931, the conception of parities being fixed, and not to be moved unless there are strong and adequate reasons which make a change desirable, should arouse much less opposition. The possibility of maintaining fixed exchanges easily, it may be added, will depend to a not inconsiderable extent on the financial support which the big centres will be able to give the countries which find themselves in temporary difficulties. If the flow of lending fluctuates violently, the possibility of exchange stability will be very much diminished. If financial support is forthcoming when necessary and not excessive when unnecessary, countries which have specialized in particular products are likely to keep their external currency relationships stable with much greater ease.

Before going on to discuss circumstances which might justify a change of parity it might be well to examine very shortly how exchange stability can be secured. Parities can be maintained by either of two methods. In the first place there is the traditional method by which each Central Bank agrees to sell or to buy gold at certain fixed prices, the margin between them being fairly narrow. The second method—it was in use to a very large extent during the War—is that by which the Central Bank buys and sells foreign currencies at particular rates. There is no inconsistency between the two methods, and they can exist side by side. The latter method—'pegging' the exchange—is certainly the more convenient when conditions are doubtful or experiments are being tried, and any experiments in *de facto* stabilization would take the form of trying to keep the pound—thinking for the moment from the standpoint of Great Britain—fixed in relation to certain other currencies. But the problem is that of being able easily to maintain a long-term stability.

Such a long-term stability requires that the parities chosen should conform to the cost and income structure of the various national

economies. The determination of what is the right parity must obviously be a long and difficult process. It will be impossible for some time to tell what the internal economic structure of the United States will be: that is, at what height prices and costs will emerge from the present experiments. Even if there were some certainty in that respect, it would still take time and experiment to discover what ranges of parity were more or less appropriate to various countries in the world. The dangers of premature stabilization are that there would be collapse the next time conditions became difficult. Such dangers must be avoided, but the whole problem is complicated by the fact that, there is no clearly defined purchasing power parity which can be deduced from a glance at a few simple statistics.

Once parities have been adopted and are being maintained with a reasonable degree of success, the question arises, Under what circumstances is a variation justified? The answer to this question reveals a sharp cleavage of opinion within the Group. Some members hold that a variation is only justified (assuming an effective international system in operation) under conditions of great emergency and as a very exceptional measure. On the other hand, others hold that small adjustments will be continually necessary from time to time.

3. *Future International Standards*

The form which an effective international standard may take in the future raises a question of especial importance. In answering this, past experience is in the main only a negative guide. The post-War gold standard experienced unfavourable conditions which led to its downfall. The parities chosen were inappropriate, and there was a tug-of-war between the three leading monetary centres—London, New York, and Paris—which made any unity of policy impossible. Leaving aside the question of gold in general circulation, the distinguishing feature of the pre-War gold standard was the unity of policy imposed on the system through London's control over international lending, both short-term and long. The effect of this control was not only to offer a strong inducement to currencies to remain in step with each other, but also to influence conditions generally. While it would be quite untrue to suggest that continuity of values was adequately secured, there was a fairly quick general response, not confined to one centre but affecting economic activity the world over, and this had the effect of mitigating the extremes of business fluctuation. It might even be suggested that had London had at her disposal the knowledge of economic forces so painfully

gained in post-War years the problem of business fluctuations might well have been reduced to manageable proportions.

But there is no prospect of any such approach in the future. The unity of the international economic system is much less than it was in the pre-War years. It is true that the breaking up of the international economic system is in part—but only in part—a result of the efforts of individual countries to protect themselves from the consequences of depression by trying to shift the burden beyond their own territories. Yet this is only half of the story. Economic unity has been impaired to such an extent that it would be wrong to expect world economic activity to be as directly sensitive to financial changes in London as was the case in the years before the War.

Nor is it reasonable to suppose that London will be able to acquire the same predominant position in the future. Even if she could do so, it would be doubtful how long she could maintain this position. The savings which London could make available for world investment would be more than equalled by similar savings in a prosperous United States. Under normal conditions France herself is bound to prove a creditor country able to influence financial conditions. The simple hypothesis of London as the world's financial dictator must be discarded. We may take it as axiomatic that within her own sphere of influence London should do her utmost to preserve steady economic development and to mitigate fluctuations. But this does not take us very far.

It becomes necessary, therefore, to answer the question: assuming goodwill and the absence of political difficulties, and assuming also that the leading monetary centres are prepared to co-operate actively, what type of monetary standard should be envisaged? The answer would appear to point to a system based on an international monetary reserve centre, of which the B.I.S. may prove to be the nucleus. Such a centre would not only help to deal with short-term transfer problems and with the elimination of frictions arising through the interaction of the various national monetary systems, but would be able to provide an opportunity for the regulation of the credit base with a view to securing continuity of values, and could help individual countries to respond more readily to any sudden and temporary calls upon them which otherwise might leave them in difficulties.

The chief consideration must be that of credit control through the centralization of reserves. The pace of world development can only be controlled if there is an appropriate contraction or expansion of credit facilities for the world in general. The use of gold would in itself not prove an obstacle, provided it were not looked upon as an

inflexible reserve and the authorities were given the opportunity to vary the volume of credit erected on a given base of gold. In this connexion projects which have been put forward for an international note issue might be of use in that they would help to provide a machinery for increasing or reducing the effectiveness of a given quantity of gold. It need hardly be stressed that the object of such a 'note issue' is not to increase credit indefinitely, but to provide a reserve basis through which credit could be expanded or contracted in the world as a whole. While the use of gold is open to condemnation as being irrational, it seems clear to the majority of the Group that it would appeal to most countries and would help to add an apparent security, and therefore that it might be well worth while for any Government (however much it may feel that gold is unnecessary) to concede its use as the price of the necessary arrangements for securing an international machinery for regulating credit in accordance with needs. But steps must be taken to ensure that the credit policies of the world's financial institutions are not left completely dependent on arbitrary alterations in the supply of gold available for monetary purposes.

The Group recognizes that these observations affect a future whose remoteness must be a matter of speculation. Nevertheless the Group would express the opinion that were such conditions obtainable, progress on the lines outlined would be eminently desirable. In the meantime it would stress the important fact that any such plan is in no way a substitute for the step fundamental to any international system—the willingness of the big financial powers to work together in a common policy. Without this, friction is bound to arise which will make any type of international system ineffective. Nor is there any way of getting round a lack of co-operation through 'supernational' control. The Group has devoted space to the examination of the working of such institutions as the Bank for International Settlements, but it has done so only because it feels that the B.I.S. is a useful instrument of a type through which the big powers could co-ordinate their policies, and it does not consider that the B.I.S. or any other device will enable this co-ordination of policies to be dispensed with.

Failing a co-ordination of policies, an international system will not work. There is no possibility of securing any common basis between the United States, adopting an intensive policy of expansion, the gold bloc countries, adopting a policy of severe deflation, and Great Britain and the countries associated with her, where revival is proceeding at a fairly rapid rate without any special measures being

taken other than the provision of cheap money. Until conditions are such that a co-ordination of policies is possible, the existence of several monetary 'groups' in the world is inevitable. And this state of affairs must continue until this country, the United States, and France feel in a position to co-operate in dealing with financial conditions the world over.

Two further considerations may be stressed. First, it is neither possible nor desirable that the B.I.S. should be put into the position of a dominating 'Central Bank of Central Banks' capable of controlling the credit policies of national Central Banks much in the way that they in their turn are able to influence commercial banks. At present the B.I.S. is precluded by international treaty from playing such a part, and the Group recognize that these limitations are not likely to be removed except gradually as an international technique is evolved for promoting and preserving the economic stability and progress of the nations.

The second consideration concerns a new development in international financial technique—that of exchange funds, of which the Exchange Equalization Fund in Great Britain provides the best example. This Fund serves the purpose of keeping liquid assets where necessary against any sudden demand from countries abroad. It is likely to prove, though conceivably undergoing a change of name and management, a necessary part of British financial policy in the future. In particular it may prove especially important if, by keeping holdings of foreign currencies with the Bank of International Settlements, it enables that institution to play a bigger part in world affairs.

CHAPTER III

SHORT-TERM POLICY

IT is now necessary to turn from ultimate objectives to questions of short-term policy. The general immediate objective can be shortly described as the elimination of disturbance from a disturbed world. The actions of business men depend on the estimates they make of the future, and if their decisions are likely to be upset by extraneous events which they cannot foresee and over which they can exercise no control, they will tend both to neglect opportunities which they might otherwise have usefully taken and to take opportunities which prove unjustified in the event. It must not be forgotten that the ultimate argument, both of those who lay emphasis on a continuity of internal values and of those who stress the importance of stable external relationships, is the same: that the effect of instability and uncertainty is to upset all the rational bases of judgement and to make expectations precarious and speculative.

1. *The Existing Situation*

The existing economic situation might be described as one of revival from an unprecedented depression. Two salient features deserve emphasis. In the first place, recovery is definitely national rather than international, though in a few cases, notably that of Great Britain, foreign trade has risen from the abnormally low depths to which it had sunk. Secondly, there is a wide disparity of conditions; the extent of revival varies very considerably from country to country.[1] In the United States the shock tactics of President Roosevelt have been followed by a very considerable, though possibly precarious, advance in the internal economic condition. Great Britain, together with other countries on devalued currencies associated with her in what is often called the sterling bloc, has also experienced considerable improvement. The gold bloc countries—France, Belgium, Italy, Switzerland, Holland—have as yet shown little or no signs of revival. In the countries which are maintaining the gold standard through currency restrictions only, conditions vary. The most conspicuous of these countries is Germany, and here there appears to have been some improvement in so far as the number of unemployed has fallen from the worst levels, but this is to a large extent due to the spreading of employment rather than to an increase in activity, and against this other considerations make the outlook

[1] The remarks which follow describe the position in the autumn of 1934.

for Germany appear particularly sombre. Japan, with an exceptional measure of currency depreciation, is economically very active, but her budget position makes it seem probable that in the future she may be faced with grave financial difficulties. Soviet Russia is outside the sphere of normal financial relationships, but the evidence of detached observers would appear to suggest that, after a period of hardship, she is making considerable progress on her own chosen lines.

It is not surprising that with such differences in conditions there are many obscure features in the situation which must make progress slow. For example, what will be the future of world trade? It is uncertain to what extent this country will have to adjust herself to a much smaller export trade in the years to come. While it seems unlikely that the proportion of her industries which Britain devotes to exports will increase, there is as yet no sufficient ground for reaching the conclusion that British exports will have to adjust themselves permanently to a lower level than in 1929. No doubt the relative importance of various British industries will change very considerably, but so will the various types of goods which enter into international trade. As long as there is a heavy demand for goods from abroad in Great Britain there is every reason to suppose that in the long run there will be a substantial demand for British goods abroad, even though motor-cars and chemicals grow in importance and cotton goods and coal fall. This point is worth stressing, not because it does much to throw light on an obscure situation, but because very often it seems to be assumed that international trade will tend to grow less and less important. It is true that, as far as the immediate future is concerned, countries and groups of countries are likely to go through an era in which self-sufficiency may be the dominant feature of policy. But to a large extent this is the result of depression, and of the fear of other depressions to come. It would be premature to assume that it will continue to such an extent that world trade is substantially reduced in the more distant future. Such an assumption arises out of depression, and may pass away with it.

A similar obscurity covers the position in the United States. At present there is some tendency to look inwards, but it is impossible to foresee to what extent America will pay attention to her export industries and to what extent she is likely to concentrate on internal development.

Finally, grave doubt surrounds the future of the gold-bloc countries. They are making every effort to remain on the gold standard and to avoid the experiment of devaluation. But it is doubtful if they

can maintain their position unless prices and costs in the non-gold countries rise fairly soon and remain at a considerably higher level than they are at present. Whether this will happen or not remains an open question. Certainly there is no ground for assuming that this will be inevitable, and in the circumstances the future of the countries on gold must remain a matter of doubt.

2. *The Question of Early Stabilization of Exchanges*

On the question, should we aim at an early stabilization of exchanges, there is a sharp cleavage of opinion in the Group. The majority of the Group maintains that, given the existing situation described above, there is little ground for urging an early restoration of stable gold exchanges on the part of the non-gold countries, or a rebuilding of the gold standard on the lines on which it was worked either in the pre-War or in the post-War period. It is sometimes urged that many of the existing difficulties are the result of the absence of an effective international standard. The implied argument is that the restoration of such a standard will cause a considerable proportion of these difficulties to disappear. But such an argument ignores the realities of the situation. Both the difficulties and the absence of an international standard are the result of general dislocation. The experiment of attempting to restore an international standard in a disordered world as quickly as possible was tried and found wanting in the years from 1925 onwards, and there is no reason to suppose that a similar restoration ten years later with a few minor differences will be any more successful in the long run.

Thus the fundamental difficulty is that conditions are unfavourable for the attempt, and are likely to remain unfavourable. The effects of economic disturbance in the world have yet to work themselves out. Adjustments have still to be made on a very large scale. There is no sure method of finding appropriate parities, those chosen would in any case not command confidence, and a period of trial and error is inevitable. Nor is there any evidence that currency authorities will have learned to work together in such a way as to promote internal continuity of values or even to avoid the frictions resulting from currency policies that are at variance one with another.

Even if, for the sake of argument, it were conceded that an early restoration of stable exchanges would do much to raise prices and to restore the volume of economic activity at an early date, the arguments against the attempt would still remain overwhelming. The increase of activity would be precarious. There would be no certainty

that the restored position would be one which could be maintained. There would be little prospect of a steady flow of international lending. With all these matters in doubt, and with possible political troubles supervening, the existence of such a system might be a positive danger, since at one moment it might tend to convey an exaggerated impression of prosperity and at the next would be peculiarly sensitive to fears concerning its future. It certainly would do nothing to solve the monetary problem.

This is not to deny that eventually some sort of an international system may be desirable and even essential. But the approach to a successfully working system will not be hastened by a general stabilization of exchanges in the early future. A system pretending to be international in a compartmentalized world is doomed to failure. The preliminary must be action by the different countries to restore a basis for monetary control internally and co-operation without. A slower approach in which the international handling of economic and of monetary problems go side by side is more likely to lead to tangible results in the long run, and if the prospects of this seem remote during times of depression they are likely to appear much more practicable once unemployment and budgetary problems cease to be as pressing as they have been in the immediate past, and in many cases still remain.

For these reasons the majority of the Group concludes that any attempt to restore stable exchanges at an early date is likely to prove dangerous and to defeat itself. While recognizing that independent national economic policies are inevitable in the near future and are in themselves a necessary preliminary to any further advance on a wider scale, they do not wish in any way to be taken as supporting the more extreme nationalistic economic policies (designed to relieve conditions in one country at the expense of its neighbours) since these, they are convinced, will only tend to make for chaos. But they do feel that no short cut will prove of value if it ignores essential differences and sources of friction. The economic obstacles have already been stressed. The monetary prelude to any workable form of international system must be closer working between the currency authorities of the big financial powers, and any attempt to base an agreement on formal considerations without regard to this closer working would appear doomed to failure.

Certain members of the Group,[1] however, are quite unable to accept the above views of their colleagues on the undesirability of the early stabilization of exchanges. They look to such stabilization as the first

[1] Sir Charles Addis, Mr. N. F. Hall, Mr. O. R. Hobson.

big step leading to a full international settlement. They set out their views as follows:

> We regard it as no accident that the rapid fall in commodity prices took place when circumstances conspired to reduce to a bare minimum international capital movements. In 1930 a speaker at the discussions arranged by Chatham House on the International Gold Problem described the situation as it then existed as 'apoplexy of the capitalistic economic system' which was suffering from congestion at its centre and anaemia at its extremities. The many measures taken both here and elsewhere since 1930 to mitigate the impact of the world depression seem to us to have failed in one important particular because they have not attacked the fundamental evil, the suspension of international capital movements.
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> Monetary policy, both national and international, as we see it, should be designed to secure the maximum employment of all resources, and this can only be done when the freest possible movement of capital across international frontiers is provided for as a central part of the system. In our view it is the extent to which capital is employed rather than the quantity of money to be supplied which is the decisive factor in determining the general level of prices.
>
> Holding this view of the nature of economic processes, we naturally dissent from the conclusions with regard to short-term policy reached by our colleagues. They explain the difficulties that obstruct a return to the gold standard and argue that because mistakes were made in re-establishing this standard in 1925 there is little likelihood that a return to it in the near future will yield more satisfactory results. We believe this view to be dangerously mistaken. The return of Great Britain to an international monetary standard in 1925 played an important part in reconstructing the international system, and to the policy followed by Great Britain must be given a large amount of credit for the European recovery which took place between 1925 and 1929. We recognize fully that mistakes were made in the re-establishment and administration of the post-War gold standard, with the result that we are to-day facing a series of economic difficulties and problems, but, in our view, these difficulties are not likely to be overcome until the problem of restoring an international standard is boldly tackled and until serious efforts are made to clear up outstanding international capital obligations with a view to restoring a normal international flow of capital between different parts of the world.
>
> We hold, therefore, that a return to gold should be the immediate objective of British monetary policy. We state this objective briefly and simply, because we feel that if it is not held in view there will be no guide available in tackling outstanding international economic difficulties. Our disagreement with the statement of short-term policy as set out by our colleagues is more than one of emphasis. It is fundamental

to the whole position. Their proposals seem to us to be defensive in character and suggest a willingness to acquiesce in present difficulties and the present low volume of international trade. We believe that unless these problems are boldly faced the inevitable result will be a decline in the standard of living of this country and a worsening of political relationships, both internally and internationally.

Our colleagues seem to us to give two answers to the question with which we are faced. In the first place they suggest, in discussing ultimate objectives, that the only way out is through international co-operation. Secondly, in dealing with the immediate future, they say in effect that the world is in such a bad way that nothing much can be done; each country must strive to carry on as best it can on its own lines. Unfortunately our colleagues relegate the first answer, with which we strongly agree, into a dim and distant future, and remain preoccupied with the idea that at the present time the individual efforts of particular countries remain the only possibility. With this pessimistic conclusion we are in hearty disagreement.

In our opinion progress can only be secured with the restoration of a freely functioning international gold standard. We wish to say at the outset that by restoration we do not imply that it should embody the more unfortunate features of the gold standard in the past. Further, we are quite as conscious as are our colleagues of the desirability of preserving a measure of continuity of values; our point is that it might just be possible to preserve such a continuity through international action, but it would be almost impossible to do it for any lengthy period in individual countries paying regard only to internal conditions at a time when the terms of trade on which their products exchange are constantly changing. Piecemeal action by various countries working with little regard for each other and striking opportunist bargains as occasion arises must in the long run prove inimical both to internal stability and to the prospect of material advance.

We do not pretend that the course which we have suggested as desirable is free from danger; we merely suggest that it is likely to involve many less dangers than the policy of doing nothing. Further we feel that an opportunity of securing a general stabilization of exchanges is likely to arise in the early future. We go on to set out our reasons for this view.

Exchange stability has been regarded as of vital importance by every country almost without exception. The lesser powers have all tried their utmost to keep their currencies in more or less fixed relationship with either gold or sterling. We know of no one who would advocate, for example, that the Australian exchange should fluctuate constantly throughout the year. In seeking to secure a general stabilization of exchanges we are only pleading for the extension of an admitted principle.

Nor can we see any particular quarter from which objection could

come. The United States has already adopted a *de facto* gold parity, and our proposals are based on what we consider the reasonable assumption that America would be prepared to go further fairly soon if a general agreement could be brought about. The anxiety of France and the other gold countries to secure the general return to the gold standard is beyond doubt.

But we advocate this policy for a further reason: we feel that there is a chance of securing those reforms which the Group discuss under 'Ultimate Objectives' at a reasonably early date. Our colleagues have suggested—and we heartily agree with them—that many of the difficulties of an international standard could be solved through the development of the Bank for International Settlements. We take the view that Britain will be in a position to secure such developments as the price of her adherence to an international standard. Clearly some set of arrangements will be necessary to take the place of the haphazard gold-exchange standard method of holding reserves, and the use of the Bank for International Settlements may provide a way out. If this country does not show its willingness to return to an international standard, she will find her power to influence the development of an international economic system seriously impaired.

While we are anxious to see the first steps being taken to secure a stabilization of exchanges as early as possible, we think it important that any such stabilization should be preceded by a period of *de facto* experiment. Further, we would emphasize that the Exchange Equalization Fund (and its counterparts elsewhere) would have an important part to play in dealing with the movement of liquid funds and in preventing unnecessary strain.

We consider that stabilization would provide an opportunity for dealing with the problems we have mentioned. The unfreezing of the world economic situation would be practicable. Tariffs and restrictions could be reduced. Uncertainty would be lessened. Foreign lending would be possible again. Further, the danger of sudden flights from particular currencies would be lessened. All these things become possible once currencies are stabilized, while they remain outside the sphere of practical politics as long as the relations between different currencies are in a state of flux.

For these reasons we differ from our colleagues and take the view that a general stabilization of exchanges in the near future is the most important contribution that can be made to the cause of economic progress.

3. *External Position of Sterling*

Having set out these divergent views on the early stabilization of exchanges, the Group turn to the immediate issue of the exchange level desirable for sterling under existing circumstances. The ensuing argument is designed to bring out the point that, while an expansionist

policy involving some rise in British wholesale prices may make a lowering of the exchange value of sterling appropriate, the lowering of sterling by itself would not be a desirable method of attempting to bring about this improvement. The Group attach importance to this point because there have been those on both sides of the Atlantic who have maintained that exchange depreciation is in itself a method bound to be efficacious in bringing about a corresponding rise of prices. They wish to make clear the reasons why they cannot accept this view, and why they feel that it may involve danger.

For the discussion of this issue it seems desirable to examine closely the way in which a further depreciation of sterling might be expected to assist in raising sterling prices or in improving British trade. When we were driven off gold in 1931, British industrial life received an undoubted benefit from the fall in sterling which ensued. But the most tangible part of this benefit was not due to any general rise in sterling prices, for there was no such rise, but to the improvement in the competitive power of our industries, both in the home market and in world markets, relatively to the industries of other countries. Before 1931 the competitive position of Great Britain in world trade was extremely unfavourable, for ever since the return to gold in 1925 many of our exporting industries had been unable to approach the prices charged by foreign competitors, with the result that they had been gradually losing their hold on overseas markets. When the slump followed, this unfavourable position was greatly aggravated, wage rates being reduced drastically abroad while remaining comparatively rigid here. To secure a substantial amelioration of our competitive position by one means or another had become by 1931 an inexorable necessity of our economic life, and there were big advantages in effecting this by means of an exchange depreciation rather than by a painful and perilous process of wholesale reduction of wages and every sort of money income.

In regard to this vital factor of competitive position, the present state of affairs is entirely different from that of 1931. At existing exchange levels, the £, so far from being over-valued, is probably under-valued relatively to the gold currencies. How it compares with the dollar at the present moment it is more difficult to judge; and it is still more difficult to say how it is likely to compare with the dollar in the near future. But the United States is primarily concerned with raising her domestic level of prices and incomes; and it would be premature, at any rate, to assume that any serious weakening of our competitive position will emerge from the American experiment. While the volume of our exports is still very low, this is not

attributable, subject to the exception of Japanese competition, to any competitive weakness, but to the continuance of depression throughout the world and to the trade impediments which that depression has called forth. In these circumstances it is difficult to believe that any further improvements in our competitive position that might be brought about by a further direct depreciation of the £ could do any real good. On the other hand, it might do very serious harm. In this respect one country's favourable position is another country's unfavourable position. Once one country pushes depreciation beyond a certain point it forces others to do their utmost to correct the position. They may try to correct it by further reducing wages and costs of production, a process harmful to general trade activity. They may try to correct it by raising their tariffs, by imposing exchange dumping duties, and by having recourse to quota schemes, a process harmful to international trade. If pressed too far, they may be driven to follow suit along the road of exchange depreciation, with the result of reversing entirely the relative competitive positions.

The gold countries, under the pressure of the existing depreciation of the £ and the dollar, have already done a good deal in the way of cutting costs and raising trade barriers, and they might do more if depreciation began anew. If the £ were to fall to any substantial extent, the possibility that the gold countries would abandon their existing gold parities would have to be reckoned with. The repercussions of such a development on world conditions generally represent a highly speculative question, but they would almost certainly destroy entirely the relative advantage which British industry now enjoys in world markets. It would appear that the potential advantages of exchange depreciation to the competitive position of British industry have been fully exhausted by the depreciation that has already taken place.

Many of those who advocate a large further depreciation of the £ are not, however, thinking of improving Britain's competitive position; they look to a depreciation of the £ to assist in raising sterling prices. This argument needs to be critically examined. The fall of the £ in 1931 did not in fact secure a sustained rise in the sterling price-level. It is true that prices might have risen had an expansionary policy been the order of the day, and not retrenchment and economy; but the conclusion to be derived from this is that it is internal expansion which matters. It is indeed probable that depreciation prevented sterling prices falling as much as they would have fallen otherwise, but it was also a powerful force tending to lower prices in gold standard countries. In determining the world prices

of many commodities, the British market is the deciding influence. Over a considerable range of commodities it was gold prices rather than sterling prices that had to adjust themselves to the reduced exchange value of the £. When in addition there is brought into account the part which the fall of the £ undoubtedly played in inducing abnormal trade restrictions and thus in affecting adversely the bulk of international trade, the contribution which it made to the lowering of gold prices can hardly be dismissed as of secondary consequence.

In contrast, the depreciation of the dollar has been of some—though possibly exaggerated—importance in promoting the rise of prices which has occurred in the United States. But the question arises, How far is this due to the fact that the depreciation of the dollar has meant a fall in its exchange value in terms of sterling? In so far as the British market determines world prices, it is natural that a fall in the dollar relatively to sterling should tend to raise dollar prices, just as the opposite movement in 1931 tended to lower them.

Pursuing the matter a little further, it may be asked what would be the probable result of raising the price of gold either simultaneously in Britain and the United States, or simultaneously in all countries. These two cases are not essentially different owing to the preponderating influence of Britain and the United States together in determining world prices. It is sometimes suggested that the effect of raising the price of gold would be automatically to raise the general price-level, and some would go so far as to suggest that the rise would be proportionate. In a world in which all monetary gold was being used as a basis of currency, and all this currency was being used as a basis of credit, this argument would have some weight. But these conditions are very far from prevailing at the present time. To-day an increase in the price of gold might merely have the effect of adding to the redundancy of the hoards of gold in some of the Central Banks. Psychological factors, however, undoubtedly enter into the question, and it is not possible to reach any exact conclusions.

To sum up, a direct depreciation of sterling standing alone would probably have more effect in lowering prices in other countries than in raising sterling prices in Britain. Though its immediate effect would be to improve our export position, it would set in motion currents which would be generally adverse. A direct depreciation of sterling and dollars together would probably have similar effects. The result of a direct increase in the price of gold throughout the world is highly problematical. The Group do not therefore recom-

mend as part of immediate policy the proposal to depreciate sterling further by directly raising the price of gold, or by deliberately lowering the exchange.

On the other hand, in spite of the not inconsiderable rise in sterling wholesale prices that has already taken place, some further rise would be desirable in view of the needs of the primary producers in the Dominions and in other parts of the sterling area and of the weight of the debt at home. In principle, therefore, what may be loosely termed an expansionist internal policy is desirable. In so far as this policy achieves success, lower exchange rates for sterling relative to the gold currencies and others might become appropriate as they are not appropriate to-day. There would be no reason to entertain the smallest regret if this were to happen (provided this were a steady and solidly grounded rise, and not due to an all-round contraction of supply, nor a temporary speculative spurt doomed to relapse), and we certainly ought not to allow the possibility that a further gold depreciation of sterling might become appropriate to fetter us or restrain us in the pursuit of our internal policy.

Accordingly the Group, while opposed to lowering deliberately the exchange value of sterling, sees no objection to some change of this character if it follows as a natural consequence of an expansionary policy and a rise in wholesale prices at home.

4. *The Immediate International Future*

The Group thus agree that the external policies of national currencies should as far as possible be so managed as to avoid any unnecessary exchange movements likely to prove embarrassing to business plans here and elsewhere; that is to say, exchange quotations should be moved only when internal conditions make it necessary. But the subject must be taken farther before it is possible to gain any coherent view of the international future.

There is, in fact, a converse to the questions already discussed. Assuming that Britain and the United States maintain approximately their existing exchange positions, there is always the possibility (though it has not arisen as yet) that they will find themselves with a considerable surplus on international account, quite apart from any influx of short-term funds that may occur. This surplus may take the form of imports of gold, or of the acquiring of short-term balances abroad by the exchange control authorities. In the absence of international long-term lending, the effect of this surplus will be to exercise a deflationary influence abroad. In the long run this deflation abroad should reduce the surplus and remove the problem, but only at the

expense of increasing stagnation on both sides. If this deflation is to be avoided, specific steps will have to be taken by the creditors on international account.

Three types of action could help to deal with this problem. First, an expansionist internal policy would increase the amount of goods bought from abroad without diminishing the amount purchased in the home market. Second, tariff reductions may further increase the demand for goods from abroad, though there are difficulties in making sweeping tariff reductions in a short period. Third, the balance may be invested abroad on long-term. All or any of these methods may prove helpful.

Only the question of long-term foreign lending in the immediate future calls for any further comment. It is in our interest to preserve a substantial measure of sound and genuine international lending, related to tangible assets. With this end in view, it is important that we should try and make full use of the Bank for International Settlements, and support any existing or projected institutions which increase the possibility of lending on sound lines.

The Group therefore concludes that there is a possibility that Britain and the United States may find themselves embarrassed by considerable surpluses on international account which fail to get reinvested. Measures should be taken to deal with such a position, if it arises. Some increase in foreign lending may prove desirable, though this will largely depend on the international political situation, and should in itself prove of help in restoring political stability.

5. *The Internal Position in Great Britain*

At the present time there is evidence of revival in Great Britain. The national finances are in a strong position. Employment has considerably advanced. Production has been increasing. The immediate object of monetary policy should be to assist in promoting the expansion of activity developing steadily and on well-directed lines.

The Group conclude that this will be encouraged through a cheap and plentiful supply of credit. Low interest rates have been important in raising security prices and lowering the cost of industrial borrowing, and—though slow to operate—have been an important factor in promoting revival. On the question of an expansive policy through government spending, in particular on public works, there are sharp divisions of opinion on the Group. These divisions partly have their origin in differing estimates of the possibility of varying the flow of public works expenditure, and partly in differences of

opinion as to the phase of the trade cycle in which we are at present. The points of view are three in number.

First, there are those who hold that it is almost impossible, in the case of a country like Great Britain, to vary the volume of public capital expenditure from year to year to any substantial extent. They consider that any attempt to do so will only result in waste and maldistribution, and hold that it is wiser, given the large volume of public capital expenditure already in progress, to concentrate on the efficient management of this expenditure rather than to aim at large efforts to divert it from one period of time to another.

The other two points of view both have this in common, that they reject the view that public capital expenditure is inflexible and hold that it is both desirable and possible to concentrate it during appropriate periods of business recession. They differ only in their diagnosis of the present state of affairs in Great Britain. Thus, second, there are those who hold that the time for artificial restoratives is passed, and that the aim should be to have an appropriate programme ready to hand if and when a further depression comes upon us. They would not urge any extra expansion at the present time, but would stress the importance of preparing for an expansion which may be necessary in the future.

Third, there are those who hold that present progress is insufficient. They would urge a vigorous policy of public works expenditure in the immediate future. They argue that the development of the motor industry has left many of the main roads inadequate and overcrowded, and that the number of new houses for which there will be a demand in the next few years will be high. Improvements in the system of water-supply are urgently called for. If the school age is raised, new school accommodation will be required. They hold that vigorous expenditure in the attempt to deal with all these problems will exercise a beneficial influence on the situation generally, and should be undertaken as quickly as possible.

Subject to this divergence of emphasis the Group are agreed in supporting an expansionist policy involving some rise in the price-level.

6. *General Conclusion*

The Group conclude that, though effective progress is likely to be slow, policies should be directed slowly and steadily towards the building-up of conditions in which an effectively-working international standard is practicable. This involves, on the one hand, a period of gradual experiment as a result of which the international

exchanges emerge at more or less appropriate levels as existing disturbances quieten down, and, on the other, the support and building of international institutions which may make possible co-ordination of policies and international credit control, as well as easing the process of international payments and providing lending support to countries in difficulty.

The Group are further agreed, however, that monetary questions form only part of the larger problem which includes the whole basis of international and national economy and which affects vitally the future of trades and areas which are tending to become derelict. The Group wish to draw attention to this larger problem—which clearly comes outside the scope of the present survey—because they do not wish by implication to be taken as supporting the view that monetary policy alone is responsible for our present troubles, or alone is capable by itself of preserving a lasting prosperity.

SUMMARY OF PART ONE

The views of the Group may be set out as follows:

Ultimate Objectives

I. International co-ordination in monetary policy is in principle desirable, though at present this may appear remote, and monetary authorities should co-operate as far as possible with this end ultimately in prospect.

II. The international system ultimately established must depend not merely on stable exchanges (as to the degree of stability there is a difference of opinion) but also on the co-operation of the leading monetary centres in contracting and expanding the basis of world credit and in trying to control the pace and direction of economic activity in such a way as to preserve continuity of values.

III. Continuity of values depends, first, on the preservation of balanced conditions in economic activity at home, and, second, on an international machinery (the nucleus of which may be found in the B.I.S.) which would enable the main financial centres to work together not only in controlling credit but also in keeping the flow of lending more consistent and in providing temporary financial help under conditions of emergency.

IV. Exchanges may be fixed either through buying and selling gold or through 'pegging'; either method should prove effective; the use of gold should be confined to international payments; any final stabilization should be preceded by a lengthy period of experiment, and under certain circumstances provision may have to be made for changes in exchange rates.

V. Great Britain as a partner in such an international system should support it as far as possible against disruptive influences, and would only be justified in breaking away from it if it failed substantially to produce the anticipated results.

Immediate Policy

VI. The majority of the Group hold that in view of the unsettled condition of world economy and finance any attempt at present to fix exchanges or link sterling either to currencies in the gold bloc or to the dollar would be premature; others of the Group maintain that a general stabilization of exchanges in the near future should be the objective of immediate policy, and that this is an essential prelude to the ultimate objectives envisaged by the Group as a whole.

VII. In the promotion of immediate British interests, direct depreciation of sterling is undesirable; there is, however, justification for a policy of steady expansion, which will bring wholesale prices to a somewhat higher level, restore economic stability, and thereafter preserve continuity of values; it would be no objection to such a procedure if a slight fall in sterling became appropriate.

VIII. Great Britain and the United States are creditor countries who may find themselves in the future with genuine surpluses on international account; increased buying from abroad or the reinvestment of these surpluses would be called for if a deflationary effect on the rest of the world is to be avoided.

PART TWO

MONETARY POLICY AND PRODUCTION

CHAPTER IV

THE ELEMENTS OF ECONOMIC WELL-BEING

WRITING some fifty years ago, W. S. Jevons suggested the need of a new branch of political economy, a science 'of commercial fluctuation, which shall inquire why the world is all activity for a few years, and then all inactivity; why, in short, there are such tides in the affairs of men'. Recent history has provided decisive testimony to Jevons's insight. We have experienced the shattering impact of business fluctuations, and have come to feel that unless measures can be taken to prevent such economic oscillation from increasing, break-down is inevitable. Many observers take the view that the working of existing monetary systems, if not the only factor, has at least been the decisive one, and that a radical overhaul of the world's monetary machinery is a pressing necessity. Others, unable to go as far as this, would still agree that the working of existing monetary systems is ineffective, and often even harmful in that instead of evening out the sequence of boom and slump it helps to exaggerate it. In short, what the world demands is 'prosperity', and it looks to its bankers and Treasury officials to play their part in bringing this prosperity about. To what extent this popular demand is legitimate remains to be seen; a preliminary step must be to analyse shortly some of the more general aspects of economic well-being, and to examine the curiously irregular nature of economic progress.

1. *Proportion in the Economic System*

The economic system fulfils its function by enabling mankind to produce, not anything or everything haphazard without regard to people's wants, but desirable things in the proportions in which they are wanted, having regard to the difficulty involved and the skill and energy available. The man who—in complete isolation—makes everything for himself, meets this problem directly; he decides what he wants (weighing up how much he would like it and how much trouble will be involved) and proceeds to make it. But as soon as a world comes into being in which specialization, and very minute specialization at that, is the rule, the problems of proportioning our supplies to our requirements assumes a special and fundamental importance. A society based on exchange must be tolerably certain that the goods which each of its members helps to produce will be acceptable to others, and vice versa. Thus it needs some indicator which will show when too much of one commodity is being produced

as compared with other commodities. For example, society must feel certain that it is not devoting too much energy and time to growing food, and too little to making clothes, having regard to the proportions in which people desire food and clothes, for we all need something of both, and will not be happy with an infinite quantity of one without any of the other.

The price system should register and help to preserve these proportions. If there is too much of one particular commodity, its price falls, or stocks of it begin to accumulate in warehouses, and output will probably be reduced; if there is a shortage, the price rises and enlarged profits attract newcomers to the production of that commodity. On the one side there are the consumers. Each consumer has certain wants which he would satisfy; his many claims must be limited; he must choose what he would have and what he would forgo, and consequently he demands goods and services of various kinds in the proportions which seem good to him. On the other side are the producers, who as a whole are attempting to provide goods and services in the proportions that the consumers would wish. The readjustment between the two sides, between society as consumer and society as producer, is not centrally directed or controlled; it results on the whole from the independent action of individual producers, each acting within his own sphere of competence; and it is broadly regulated by the profit which each producer feels and finds that he can secure. If prices are such that he thinks he can with profit start a new business or extend an existing business, he does so. If prices are falling and he finds himself in a position where he cannot secure an adequate return, he tends to cut down his production, while new entrants into that particular line of business will be effectively discouraged. In due course the price of his particular product will begin to rise once more as the proportion reasserts itself. It is through the relative profitability of different industries that production is directed to meet demand. The tendency is for the return in various industries to even itself out, and a return below the normal in one line of production or above the normal in another is a signal that too many goods of the first sort and too few goods of the second sort are coming on to the market. Thus it is that the profit incentive and competition link together production and consumers' demand, in proportion to their desires expressed in terms of money claims on the total output of the community. Hence the importance of the price system in registering demand and directing production.

Such a picture is, of course, a formal and limited one. The 'demand'

in question does not correspond in any way to the basic needs of human beings; it is demand in terms of money alone. The direction of production bears no specific relation to human desire in general, but only to the desires of those that can pay for what they want. Food is produced not because people are hungry, but because they are hungry and buy food out of their wages, dividends, pensions, or other sums that they receive. If some people are unemployed and the total amount of money being spent falls off, demand falls off irrespective of what people would like to have. Whether or not incomes are fairly distributed, whether or not one can so arrange things that incomes and employment can be stabilized in such a way as to prevent fluctuations in demand, are important questions which are not affected by the considerations set forward above. All that can be fairly said is that, given certain conditions of demand, the supply of goods coming into the market will tend to conform to the choice of consumers. The point is that, given these conditions of demand, there is no purpose in setting people to work to produce goods conforming to the choice of nobody at all.

Even the formal picture requires some qualification, since monopolies and other restrictions on competition dull the automatic response. Nevertheless, in the long run—whatever the jolts and jars and imperfections—the price system works in such a way that what is produced tends to conform to people's demands and to anticipate what they ask for, and the production and consumption of particular articles are brought into line with each other. The significance of this proportioning process is fundamental, and in the light of it methods for getting out of a slump must be judged. Any successful method of combating depression must seek to maintain or assist in readjusting this proportion, or further difficulties will result. Without proportion the fruits of specialization are lost, and the whole machine is thrown out of gear.

2. *Growth and Change in the Economic System*

These proportions to which the economic system works are never fixed. They are in a constant state of flux, changing more rapidly or less rapidly from time to time. Sometimes the impetus comes from consumers, sometimes from producers, or from nature itself. Not only do the preferences of individuals change on the side of demand; there are also constant changes in the circumstances which govern supply. And a change on one side may provoke a whole series of changes on the other.

Changes in demand—that is in the preferences of consumers—may

have many causes. They may be due to an alteration in general conditions; it is natural that the desire for heavy underclothing should lessen in a heat wave, and that the orders for ice cream should fall off in mid-winter. Apart from changes of this sort, which can largely be foreseen, there are constant variations in taste and fashion which are not susceptible of any one rational explanation. Further —and in an even more far-reaching way—changes in population and in the rate of its increase or decrease, and in its age distribution, will alter the character of what people require. A fall in the number of families means that fewer new houses will be needed every year, and this in turn involves a reduction in the number of workpeople and the amount of capital devoted to the production of new houses. An undeveloped country, with a fertile hinterland, a high birth-rate, and a large flow of immigrants will need new railways, bridges, and roads; this may no longer be the case on anything approaching the previous scale when the development of the country reaches an advanced stage. Changes in demand are thus dependent on circumstances, and not merely on the whims and fancies of individuals. The new requirements which follow an earthquake, an epidemic, or a change in birth-rate are far more sweeping than those which follow fashions in luxury goods, though in civilized countries these can be sweeping enough.

Changes also come from the side of supply: a good harvest or a bad, the discovery of a new mine or the exhaustion of an old one, have obvious results. And to-day we have added to the natural causes of change, the whole range of scientific research and improving technological knowledge. Research brings to light improved agricultural methods, and new means of combating pests. The researches of the Dutch have greatly enlarged the supply of sugar coming from the East Indies in the course of a few years, while in North America improved varieties of wheat have increased the crops that farmers could grow on a given area of land. Simultaneously the farmers' immediate expenses have been further reduced through the mechanization of agriculture. Thus not only has science enabled the agriculturalist to grow the equivalent of several blades of grass where one grew before; it has given him machinery which enables him to do so with fewer labourers. The same is true of manufactured goods. Scientific invention plays its part in building up a new and improved productive technique which not only makes easier the production of goods with which people are already familiar, but adds entirely new goods to the range of choices with which the consumer is faced. Mass-production methods have lowered the cost and increased the

supply of all types of goods from motor-cars downwards, while the post-War period has witnessed the spectacular arrival of things which by now we take completely for granted—wireless entertainment, talking films, zip-fasteners, to take examples from a list which could be increased indefinitely.

But to separate the two sides of the account, to suggest that changes only occur from the side of the consumer or from the side of the producer, is to make a quite artificial simplification: the two sides are intimately bound together. A technical development which enables the price of a particular commodity to be reduced may increase demand out of all proportion if the commodity is now within reach of the pockets of a larger proportion of the population. Conversely, an increase in demand, and the larger market which follows on it, will help the introduction of cheaper productive methods. Often enough business men have discovered that the two may be simultaneous: a Ford or a Woolworth, faced with the dilemma that cheaper production will mean a larger market and a larger market will justify cheaper production, has taken a risk and has lowered prices in order to build up the larger market which justified that lowering. Supply and demand are acting and interacting in an ever-changing world.

Lastly, there are a whole series of changes which may be traced to political rather than to economic influences. Perhaps the most significant of these are changes affecting the distribution of income between different classes of society. The more millionaires there are, the larger will be the demand for Rolls-Royces, steam yachts, champagne, and large country houses; the more working-class standards of living are rising, the greater will be the demand for wireless sets, books, comfortable cinemas, amusements of the type that cater for a wide public. Political factors may help to create conditions of one kind or another, and accordingly demand varies and exerts an influence on the whole of the economic structure. Further, taxes vary from budget to budget, and bear with more or less weight on this or that part of the economic system. Tariffs are being raised or lowered. Restrictions and embargoes come into force or are abolished. Quotas and similar arrangements have to be considered. Producers' agreements come into being, or come to an end. All these are in themselves causes—and often also consequences—of change.

But the effects of change go deeper than might appear at first sight. Society is not only concerned with preserving proportion in the output of different kinds of consumers' goods; it must also preserve proportion in the output of the tools and materials necessary to

provide these goods. A comparatively trifling variation in demand may cause very considerable variations as far as the capital goods industries are concerned. It is often pointed out if the production of cotton goods is steady, and one-tenth of cotton machinery is renewed each year, a sudden 10 per cent. increase in the demand by consumers for cotton goods will mean a 100 per cent. increase in the demand for cotton machinery in the first year, but only a 10 per cent. increase in the annual demand for machinery in the long run. Such an illustration is, of course, exaggerated. If entrepreneurs judge the position correctly, the rise in the price of cotton machinery, in face of the doubling of demand, will be such as to damp down the increased demand, to spread it over a period, and to reduce it to more manageable proportions. It follows that the prices of capital goods should be as sensitive as possible to changes in demand. But the illustration does serve to bring out strongly the significance of the pricing process in regard to capital goods, and to show how opportunities for devastating misjudgement can arise. An exceedingly important clue to the irregular fluctuations in mankind's real income, usually referred to as the 'trade cycle', is to be found in this fact, that mild changes in the demand for consumption goods for immediate enjoyment mean sweeping changes in the demand for capital goods.

Thus the preservation of proportion in the economic system is something elusive, for both productive possibilities and consumers' wants are altering from day to day. To maintain complete proportion continuously is an impossibility. To be constantly working towards proportion, and to be preventing drift away from it, is a fundamental economic task. And it is a difficult task because it has to be carried out in a specialized, growing, and changing economic system.

3. *Fluctuations in Business Activity*

An important factor in business fluctuations lies in the discontinuous nature of the demand for capital goods, a discontinuity affected by forces of all kinds, monetary and non-monetary.

As soon as the call for capital goods slacks off, the men attached to the industries producing them become unemployed, and are forced to spend less. The profits of those who provide consumers' goods are affected. Turnover decreases; prices fall; debts become more and more burdensome. The fact that the production of consumer's goods is less profitable only serves to reduce still further the demand for capital goods (and in due course the demand for consumers' goods), and a vicious spiral of depression is under way. As long as

the volume of demand for producers' goods is liable to vary and to swing from one extreme to another, there is an inherent instability about the economic system.

Variations in the rate of investment will be affected by many factors. New inventions, or the discovery of new markets, for example, may start periods of feverish activity which in their turn lead to stagnation as the obvious opportunities for development are exploited. The railway age provides an example of such a period of invention; war, with its sudden and temporary demand for armaments and munitions, provides another.

But periods of feverish activity less spectacular than those provided by railway booms or war also tend to be followed by slumps. A boom makes inevitable a good deal of bad lending and unwise investment, as a result of which entrepreneurs must be disappointed of profits. In the struggle to pay debts and liquidate superfluous concerns, most business men who are making plans for the future become frightened. They decide to postpone the execution of their plans; a falling off in the flow of new investment is the result.[1] The picture may be clarified by considering what happens from the point of view of goods and of money. On the one hand, people are deciding, consciously and unconsciously, the proportion that is to be kept between things for present consumption and things for future production. At any given moment not only are men engaged in providing goods and services for immediate use, but they are setting up factories and plant, building railways and harbours, and performing other tasks in order to prepare the way for new or improved production a long time ahead.

On the other hand, looking at it from the point of view of money, people are spending a part of their incomes and 'saving' the rest. The saver may pay his money into a bank, or deposit it with a building society, or use it to buy securities, or put it into his own or somebody else's business. It is out of these savings that the process of capital accumulation is financed; and in the normal way the flow of savings should be invested: that is, be crystallized in the form of capital goods.

But the investment of saving is not an automatic process. If no business man plays a part in borrowing money from the bank or from the saver direct and using it to buy new buildings or raw materials or stocks of goods, the saving proves abortive from the point of view of the community, since a sufficiency of capital goods is not purchased to justify their production at the old level. In the

[1] On this and what follows see *Monetary Policy and the Depression*, pp. 21–6.

contrary case, too much money may be directed to the purchase of capital goods, compared to the quantity of savings—in which case boom conditions result. The people who save are only partly the people who invest, and there is no guarantee that the amount invested will not fall below or rise above the amount being saved.

This picture is important because it brings out the reason why the fact that saving and investment get out of gear affects the whole, and not merely a part, of industrial activity. It may be that investment falls short of saving[1] because the political outlook makes opportunities of making profits in the future seem uncertain. Entrepreneurs may reduce their spending, while private individuals save as much as before. Once unemployment goes beyond a certain point, the demand for consumers' goods is ineffective, and the whole downward spiral begins.

This, it must be emphasized, is not an explanation of the depression: it is merely a picture of depression itself. It explains, it is true, why a depression that is well under way tends to gather force and go from bad to worse. It throws no light on the particular reason why to begin with savings fail to get invested, that is, why entrepreneurs do not feel confident of sufficient profits in the future. The causes of this may, as we have seen, be of many kinds—undue monetary restriction, past misdevelopment, a falling off after a period of unduly rapid advance, a cutting up of markets. Just as profits breed profits, so losses breed losses, and fluctuation is the result.

Whether fluctuations are likely to get more or less violent in the future is a question which cannot be answered with any show of certainty. The after-affects of the last War will be less of a disturbing influence. Even if the significance of War Debts and Reparations has tended to be exaggerated, there is no doubt that the War, by calling new industries temporarily into being and allowing old industries to fall temporarily into abeyance, brought about dislocation and highly disturbing effects upon the balance of international payments and the stream of international investment. As time passes the War influences will be reduced, and this appears to promise a greater stability. On the other side of the account must be set certain factors which suggest that—other things being equal—oscillation will become greater. With increasing wealth, more and more of the world's economic activity will be devoted to catering, not for

[1] i.e. the flow of money will decrease as the velocity dwindles. In this sense the quantity of money decreases though the volume of bank deposits and currency in circulation may remain unchanged and perhaps even increase.

necessities, but for 'optional' expenditure liable to change its direction under the influence of taste and fashion. Further, there is all the greater scope for individuals to change the total volume of their expenditure even when there is no change in income. Lastly, the decline in the rate of growth in the effective market due to trade barriers and the fall in the birth-rate does make for greater trade instability, even though in the long run a stationary population may prove a stabilizing factor. All these reasons, coupled with the fact that as the specialization of the productive system grows more intense it is more sensitive to the impact of change, go to emphasize the very real possibility that business fluctuations will become more severe if they are left to themselves, and to point to the necessity of a technique which will minimize their incidence.

This is hardly a question of putting an end to trade fluctuations. Abnormal circumstances can arise in which a rapid increase in the demand for capital goods is to be tolerated, if not encouraged.[1] Further, it seems probable that in a world which is changing from one moment to another, some fluctuation is bound to come about in the course of adjustment and readjustment. For practical purposes the immediate question is not whether fluctuations can be eliminated altogether, but how and to what extent can monetary policy help in reducing their incidence.

Monetary policy can play its part through its influence on the terms of lending and on conditions generally: it can make them more or less favourable to new development. The task is a double one. In the first place, monetary policy should aim at smoothing out the flow of investment so that it balances voluntary saving and does not outrun or fall short of it. It must be the business of the banking system in order to preserve stability, to endeavour to regulate the flow of money through appropriate changes in the terms of lending and otherwise so that the proportion between the supply of capital goods coming on the market and the savings devoted to their purchase is maintained. The problem here is so to arrange things that we are

[1] For example, war. Theoretically, no doubt, a Central Bank could prevent the disastrous 'over-investment in munitions' by refusing to make advances to the Government and raising bank-rate to a prohibitive level. Such a policy would bring the over-investment (and the war) to an end, on the hypothesis—obviously quite absurd—that the bank would be allowed to pursue it. A more interesting case is that of a boom in railway building. Will a country be better off if it allows the boom to run its course and then collapse (for depression will then be the price of a quickly developed network of railways) or will it be better for it if the development of railways takes place gradually over a period of years? It hardly seems safe to take it for granted that the country must inevitably be better off under the latter hypothesis.

buying consumption goods or factories (and so on) in the same proportion as individuals in the mass are spending or setting aside their incomes.

But this by itself is not enough. A second aim must be to try to ensure that saving is used to make more efficient the methods of production and not merely to duplicate them unnecessarily. At the same time, the resulting investment must not take such elaborate forms that the processes set up prove unprofitable owing to the fact that an adequate market is not realizable. If this does not happen, a temporary balance between savings and investment will in time lead to unavoidable recessions. The problem of preserving proportion remains, and is not solved automatically once the stream of voluntary savings matches the stream of investment.

CHAPTER V

MONETARY ACTION AND ECONOMIC ACTIVITY

It has been argued that if business fluctuations are to be avoided the flow of investment must be evened out as far as possible and brought into relation with a voluntary saving kept at an appropriate level, and that at the same time the price system should be allowed to work in such a way that this flow of new investment does not needlessly get directed into the wrong channels. Such generalizations have value in so far as they attack the underlying problem and point to a line of approach, but are not intended to touch the problem specifically. Before one can discuss such fundamental subjects as the weapons at the disposal of monetary authorities and the extent to which they are likely to prove adequate, various preliminary questions have to be disposed of. For example, to what extent does a falling off in business serve a useful purpose in redistributing activity and restoring balance, and to what extent does it do unmitigated harm ? Further, the criteria of action have to be considered. In accordance with what principles should a Central Bank act if it is to influence the current economic situation in such a way as to minimize the ups and downs of business fluctuations ?

1. *Aspects of Depression*

The analysis of the working of the economic system which has been developed so far has set in relief two significant aspects of depression. The first is the irregularity of the demand for capital goods, and the dislocation which may come about in the economic system when mistaken policies or fluctuations in demand make necessary shifts in the direction in which productive activities are specialized. These shifts can only be brought about with a certain amount of friction. Maldistribution of activity is bound to occur in a moving economic system, and as a result adjustments are constantly taking place. On the other hand, there are times when this dislocation accumulates and becomes exceptional, and these periods are usually associated with a boom because it is under boom conditions that opportunities for mistaken investment are at their height. As a sequel to such dislocation, slump seems almost inevitable.

The second aspect of depression centres on what might be described as the 'inherent tendency to expansion or contraction' of the economic system—the tendency, other things being equal, for an upward or downward movement in activity to proceed at an

ever-increasing rate until the fundamental circumstances have changed. Now it is obvious, in the case of a slump, for example, that there is no particular connexion between the size of the original maladjustments which call for rectification and the depth to which the slump may go. The world depression of 1930 onwards probably had certain features which may not repeat themselves, but nevertheless it is difficult to maintain that the misdevelopment before the depression was so great as to account by itself for the tremendous collapse which ensued. It seems clear that, once difficulties have occurred, the subsequent collapse will be affected by a large number of factors which are not dangerous in normal times but which may have terrifying effects under abnormal conditions, in particular any lack of flexibility in monetary systems and any inability on their part to stand strain. Herein lies the clue to collapse which otherwise would appear inexplicable.

The distinction is an important one, and to make the argument clearer it will be convenient to describe as 'primary recession' that part of depression which is due to originating maladjustments, and as 'secondary recession' that part due to the cumulative momentum which any substantial downward movement tends to acquire regardless of the initial impetus. It is necessary to point out that secondary recession may come to play the major part in the depression and that primary and secondary causes tend to merge into one another.

Starting with this distinction, several conclusions suggest themselves:

First, monetary policy should aim primarily at preventing maladjustments occurring, that is, at eliminating the causes of 'primary recession';

Second, once maladjustment has occurred monetary policy should do nothing which increases this maladjustment or holds up the tendency towards readjustment; and

Third, monetary policy should do everything in its power to counteract 'secondary recession', which serves no useful purpose whatever, provided this action does not interfere with the action of the primary recession in redistributing activity.

These conclusions require amplification. The first is the most important: the prevention of sudden and artificial spurts of activity will in turn prevent a subsequent reaction. The platitude that prevention is better than cure applies in matters of banking and currency, as well as of hygiene. The smoothing out of booms is not only a question of monetary action to slow down the general tempo of economic activity, but also, as will be suggested subsequently, one

of partial control through banking action of the direction[1] as well as the volume of lending.

The second conclusion suggests that monetary policy should do nothing to delay readjustment, once dislocation has occurred. It hardly needs expanding. But incidentally it may be observed that readjustment may be greatly accelerated by action which falls entirely outside the sphere of the monetary authorities. The existence of surplus capacity in the British cotton and iron and steel industries is a notorious fact admitted by all competent observers, and there seems no reason to suppose that direct attack on problems of this sort would have brought anything but good in its train.

The third conclusion suggests that monetary policy should do everything in its power to counteract secondary recession. There is always the danger that fears of what may happen will lead to such intense efforts to maintain unnecessary liquidity that the fears will be realized. While a steady pressure to secure reorganization and a better distribution of resources may be desirable, there is nothing to be said for a collapse so violent that it tends to stay, for the time being, good and bad tendencies alike. This conclusion must be qualified: measures at combating secondary recession should not be pursued to such an extent that they created a spurt so vigorous that it preserved old maladjustments or brought into being new ones.

2. *Price Movements*

The next stage must be to proceed from the general to particular manifestations, and to develop this approach in terms of prices and of volumes of goods.

In *Monetary Policy and the Depression*[2] the price movements of the period 1929–33 were examined in some detail, and an attempt was made to sum up some of their consequences. Statistics were given to show how different prices had been affected in very different ways, and how the relationship between individual prices and groups of prices had been disturbed. Not only was stress laid on the unequal incidence of the depression on different forms of activity, but also on the redistribution of the flow of wealth between the sections of the community which depression tends to bring about. The effect of a sharp fall in prices and activity is to dislocate and disturb the price structure as a whole, and to make more onerous the

[1] The importance of this lies in the fact that booms are usually associated with the rapid expansion of particular industries, and not merely of industry generally.

[2] pp. 26–32.

series of fixed money obligations which forms the background of business activity.

The most conspicuous of these effects—and the one which has been the most often emphasized—is the tilting of all contracts in favour of the creditor and against the debtor. This gives those with fixed incomes a considerable increase in real wealth, since their money incomes remain much the same while they get the benefit of lower prices. On the other hand, those who depend on the profits of a business are very severely hit. While the owner of a factory may find himself working at a loss, the owner of a mortgage on it continues to receive the full money amount of his interest. The debtor has to pay more in terms of the goods he produces, while the creditor actually gets more in goods and only loses when circumstances become so difficult that the debtor is forced to default.

But it is sometimes overlooked that in addition to this static effect of *fallen* prices there are still graver dynamic effects of *falling* prices which cannot be redressed by the writing down of money obligations or through the bankruptcy court. A 10 per cent. change in prices in an industry may mean the turning of a substantial profit into a substantial loss. The result must be an almost complete cessation of new activity in that industry. Not only will new developments be postponed, but even the regular renewal of machinery may be cut down. As we have seen, consequent unemployment in the trades that supply machinery aggravates the fall still further, and depression tends to be cumulative.

It is this paralysis, caused by a really severe fall in prices, which has attracted so much attention. In itself it admittedly serves no useful purpose, for readjustments come about not only through pressure on the one hand but also through alternative openings and opportunities on the other. The effect of what has been described above as secondary recession is to destroy the alternative openings and to exaggerate the dislocation. It does not bring about movements of economic activity calculated to restore a proper balance between the things we are producing and the things we should like to have.

For these reasons economists hold that a healthy monetary policy should have the effect of keeping price movements within reasonably narrow bounds. The demand for a greater measure of continuity of values has its origin in the need for greater certainty as regards the directions in which the income of the community flows.

'The object at which monetary policy must aim is to secure and maintain a proper adjustment between costs and receipts. . . . Only with such

an adjustment will profits be able to play their part in economic progress, and under the existing system their part is all important, for two reasons: first, it is only when business men see an opportunity of making profits that they will be prepared to embark upon new enterprises, and, second, it is largely out of profits that new capital development is financed.'[1]

Once a healthy relationship between prices and costs has been secured, it will be disturbed either by an increase in the profit margin (which may lead to a boom through good prospects exaggerating the flow of new investment) or a decrease (which may lead through a slowing-down of investment to a slump). A reasonable profit margin will prevent the pace of economic progress getting too fast or too slow and will also tend to minimize the possibilities of bad investment.

Thus the Group are agreed in looking to a greater measure of continuity of values as an essential aim of monetary policy. When, however, we come to analyse the conception 'continuity of values', there are differences of opinion as to how it can most effectively be interpreted. Some would hold that Central Banks should have the duty put upon them of directing their monetary policy in such a way as to keep a particular price index at a constant level. Others maintain that such a conception is too narrow, and that monetary authorities should aim at smoothing out economic activity in the light of all available information, and should in particular pay attention to the level of industrial profits. Broadly speaking, the former school hold that the simplicity of a constant price level more than outweighs any theoretical disadvantages; they suggest that, whatever may be said theoretically for paying attention to all indicators of economic activity, in practice the instruction would be so vague as to make it liable to misinterpretation, and perhaps quite ineffective. The latter school argue that the dangers of putting one's trust entirely—or even mainly—in one particular index outweigh the practical advantages. But both points of view agree in the desirability of continuity of values, though some would allow more elasticity in their interpretation than others. These interpretations must now be examined in some detail.

3. *The Proposal for a Constant Price Level*

Suggestions for stabilizing prices usually take the form of the proposal that monetary policy should be directed to ensuring stability in an index based on the prices of certain selected commodities. A general index would theoretically be more satisfactory, but it would not be possible to construct a complete and satisfying price index composed of all the goods and services which people consume in the proportion in which they are consumed. It would be equally impossible

[1] *Monetary Policy and the Depression*, p. 35.

to construct a similar index where the proportion is that of the money payments which are made during the course of production of all these goods and services. The immensity of the task alone is enough to condemn it, quite apart from the fact that even if it could be undertaken its validity would still be questionable.

One difficulty centres on the comparison of what purport to be the same commodities at different dates. This especially concerns manufactured goods. It is an admitted fact that during the last ten years motor-cars have fallen very heavily in price, but there can be no valid comparison between the motor-car of to-day and the motor-car of ten years ago on account of the technical improvements which have taken place. However confidently we emphasize the fall in price, we know that to attempt to measure this fall will lead to widely differing estimates. What is true of motor-cars is true of all of the wide range of manufactured goods which are constantly changing in character in the light of new preferences and new inventions.

A further reason for doubting the reliability of any index which sought to give a complete picture of *general* price movements centres on the difficulty of introducing new commodities. When a new invention comes on to the market, initial sales are small and the price is high. As soon as it spreads, sales increase very rapidly and the price is lowered. If the picture is to be accurate the weight given to this commodity should be greatly increased. Consequently at a time when newly invented articles are rapidly falling in price and percolating to a wider public, as they undoubtedly should do, their effect on any index must appear to be a depressing one.

The difficulties, then, which surround any attempt to build up a general index of all commodities would appear to be insurmountable, and we are forced back to considering an index covering only a selected list of commodities or services. The list of items to be included in the index has aroused some controversy. Should it be confined to commodities or should it also include such things as wages and salaries, rents, the capital value of land and building, and even stocks and shares and other marketable securities? Undoubtedly a case can be made for spreading the net wide, as the longer the list the more representative would it be, and the more accurately would it indicate the extent of any changes. But simplicity and expediency point strongly to a narrow definition, and suggest that a wise selection of particular commodities adequately weighted would form the most satisfactory basis on which an index adapted for practical use could be constructed, this list of commodities and their weighting to be revised from time to time.

The arguments are in favour of a wholesale price index as against a retail one. If the wholesale index is kept stable there is little reason to expect sweeping changes in retail indexes, since wholesale prices are much the more sensitive. Further, a satisfactory retail index must be difficult to construct, and consequently might prove an unsatisfactory guide. While stable wholesale prices should mean fairly stable retail prices, a stable retail price level might still allow considerable changes in the general level of prices of goods sold wholesale. The high proportion of overhead costs makes the retail price level very rigid, and this rigidity is increased by the growing demand for 'service' in addition to goods. But we have no reason to expect the relationship between wholesale and retail prices to remain fixed. Under dynamic conditions—particularly in the future when population growth may be expected to slow down—economic development will almost certainly take the form of greater elaboration in the later stages of distribution.

Especially if there is to be any hope of international co-operation, the argument would seem to point in favour of confining attention to the prices of international commodities which enjoy a world-market.

'We are driven back therefore on some more rough-and-ready international aggregate of objects. I do not think we can do better than take (say) 60 of the standardized foods and raw materials of world-wide importance, and combine them into a weighted index number, the aggregate importance of each article being determined by the money value of the world output of it calculated in the producing countries, and its price by the weighted average of its f.o.b. price in these countries, each year being compared with the next by the chain method or link relatives.'[1]

Mr. Keynes's list is a substantial one. It starts with wheat, goes on through a number of grain crops to potatoes, sugar, and meat, and includes commodities such as coffee and tea, a number of raw materials, wool, silk, rubber, coal, and a number of metals. In addition, among other things, it covers certain chemicals in which there is a substantial world market. Further, he mentions the possibility of including sea freights. He defends this index against other and more refined indexes on the ground that there is no index of a more refined type which is capable of an international application.

Leaving aside for the present the international implications, it must be admitted that the absence of fluctuations from such an index would appear to preserve the world from many of the disadvantages which far-reaching price movements bring in their train. To aim at a constant level of prices in terms of an index would involve a clear-cut

[1] J. M. Keynes, *Treatise on Money*, vol. ii, p. 391.

conception of the stability of purchasing power. The ordinary man and woman making contracts in money would have a much more definite conception of what they were undertaking in terms of physical things.

Yet the chief advantage of such an index would be its simplicity from the point of view of administrative purposes. The duty imposed on Central Banks is clearly defined. The success of Central Banks policy is, at any and every moment, open to public examination, and the possibility of interference by Governments or other interested bodies is reduced to a minimum. Advocates of the above point of view point out that to impose on a Central Bank the ill-defined duty of maintaining economic activity at a steady level is to leave the Bank with no clear indication of what it is expected to do. The objective of a constant price level in terms of an index number makes the object of management easily understood.

On the other hand, there are disadvantages and limitations which must be recognized. If the conception of an index number is supported on the ground of its simplicity, and the ease with which it shows whether a policy is being successful in attaining a given objective, it is criticized on the ground that its very simplicity involves big dangers. If an index number is to be the only—or even the chief—indicator, other danger signals may be ignored. While an index number clearly has very great uses, and may bring good results if it is taken as a guide, in the long run it may allow a situation to arise which must bring disaster if it goes unchecked.

One difficulty lies in the fact that the conception of a 'world price' in certain commodities is to some extent an artificial one. The growth of protected areas in which the price of, say, wheat is kept artificially high through Government restrictions means that the price of wheat coming on to the world market outside protected areas tends to be artificially low. This applies to a wide range of commodities with the result that 'world prices' are not as representative and as full of meaning as they appear to be at first sight. An index of world prices would, therefore, in many respects be artificial.

But the mere fact that the selected list is a partial one provides a basis for a strong theoretical line of criticism. This criticism holds that there is a very real danger that the direction of investment may be warped. If we assume that, say, some sixty standardized commodities are chosen, and that on balance the production of these sixty commodities will remain profitable (as should be the case if the index number is kept stable) the world is provided with what appears to be a lasting opportunity for safe investment provided risks are spread

over all the commodities in the index. It is true that the profits will not be very great, but the certainty of the investment will tend to make it very attractive to lenders and to entrepreneurs. If the possibility of this happening is admitted, it follows that such an index number cannot be used unless those responsible for using it look beyond it and see how far proportion is being maintained in the economic system. The index itself is no guarantee of proportion or of real economic stability unless it is critically interpreted.

Many economists hold that the history of the last few years does in fact show that capital often goes in wrong directions largely for non-economic reasons. There is always a tendency for money to pour into industries which have had a successful record in the past even though the likelihood of their being successful in the near future is remote. There is, further, a general tendency (dictated mainly by non-economic considerations) for excessive production of agricultural commodities at a time when the world is in need rather of elaborately differentiated manufactured goods and of specialized services.

'The prejudice in favour of primary industries as a likely absorbent of labour which has proved to be superfluous elsewhere is shown by people of the most divergent political colours, and is no doubt the result of mental habits deeply ingrained by centuries of constant dread of famine. The idea is apparently part of the economic programme of the German Nazis; it is an article of faith with almost every influential section of public opinion in New Zealand; the authors of the Report of the British Liberal Industrial Inquiry believed that "the remedy for the present unsatisfactory position of British agriculture is the same as that suggested in the case of our great export industries—the taking of such steps as will secure an increased net return per head of those engaged. The resulting increased product per acre and per head will make possible a proportionately increased return to those engaged, whilst at the same time leading to an increase in the area under cultivation and to an increase in the numbers engaged" (pp. 326–7), and Professor J. D. Black, Chairman of the Advisory Committee on Social and Economic Research in Agriculture of the Social Science Research Council, believed that "it is easy to conceive of a different working of our so-called competitive system which would give us more farmers and better rewards at the same time" (American Economic Review, Supplement, March 1926, p. 138). While there is so much difficulty in convincing people that the growth of knowledge on which economic progress depends inevitably means a reduction in the relative importance of primary production as a source of employment, and is, in fact, wasted if this reduction does not occur, it is not surprising that similar misapprehensions concerning the necessity for changes in the distribution of capital cause serious dislocation, especially if there is reason to believe, as has been suggested here, that in some of the newer

types of production which economic progress makes possible, the relative importance of capital as a factor of production may be smaller than in the old.'[1]

Now it is at the least an unfortunate coincidence that those very articles to the production of which capital would appear to be unduly attracted are the ones which would form a basis for an index number. Mr. Keynes's list (discussed above) consists mainly of standardized primary commodities which enjoy a world market. There would appear to be grounds for supposing that there is a tendency to over-production in precisely these ranges of commodities. If an index number of this sort is to form the criterion of monetary policy it will be thought that monetary policy has resulted in the setting up of valorization schemes, and the temptation for new capital to be invested in the production of these commodities will be increased. Either of two results may follow. The attempt may break down owing to the general over-production of commodities on the list. Or else steps will be taken artificially to limit the amount of these commodities produced. In the latter case the index number ceases to have any validity as a guide to general economic policy as it becomes completely insulated from general conditions.

This argument can be extended to touch on the whole question of price indexes generally. A price movement is not the only indicator of maladjustment or lack of proportion. Prices may remain stable, and instead of a price fall there may be a piling up of goods in warehouses or reduction in output. It is theoretically conceivable that there might be severe depression during which prices remain absolutely stable but in which all the consequences of a price fall are reproduced in their strongest form. Profits would disappear and debt burdens become unbearable because of the falling-off of sales instead of the fall in prices. Incomes and wages would be reduced through unemployment. Losses would be incurred throughout industry. New investment would fall off, and bring with it a falling-off in demand. Different industries would be affected in different ways and yet—*theoretically* this can well be so—prices, wages, and incomes (of the goods that are sold and of the people that are still employed) remain exactly where they were. The reduction has taken the form of a reduction of output or of sales and not of price. While this theoretical possibility may be ruled out[2] in considering the practical

[1] Allan G. B. Fisher, 'Capital and the Growth of Knowledge', *Economic Journal*, Sept. 1933, p. 386–7 f.

[2] But not entirely. Cf. Professor Ohlin: 'On the whole, then, we may say that, when once a depression has set in, a reduction in the quantities produced

situation, it seems clear that price movements may become an inadequate guide unless they are interpreted in the light of the volume of goods being sold.

A further criticism is based on the ground that a price index of the type discussed is insensitive. The warning signals do not come quickly enough, and America's experience from 1925 to 1929 is adduced as an illustration of the moral.[1] Reasonable stability of prices, it is suggested, is mainly a proof of a right policy, and not a criterion of what is to be done at the moment. Here, again, is a case for interpreting data as widely as possible. A monetary authority is not concerned with what prices are at the moment, but rather with how they are likely to move in the future. Successful forecasting of price-movements calls for a more substantial basis than that of their history. Prices must be interpreted in the light of many considerations: they do not explain themselves. There is a danger that outward stability may only be the prelude to collapse.

But these criticisms hardly dispose of the matter. On the one hand, we are weighing practical considerations, on the other theoretical ones. There is no method of putting the two in the balance against each other, and only experience in the long run can decide. It might be possible for all the theoretical criticisms to be completely valid, and yet for a constant price level to remain the best available guide for practical purposes.

4. *The Relationship between Prices and Costs*

The view so far discussed has been that of those who hold that to aim at a constant price level provides the most practicable method

and marketed can very easily take place without being materially reflected in the index numbers representing the average wholesale or retail price level. E.g. a fall in the prices of articles of domestic manufacture may be counterbalanced by a rise in the price of imported goods. But, even if the former price level is kept stable, demand and production may decline.

'Does this imply that a price-stabilization policy like the Swedish, initiated in the very middle of a depression, can serve no purpose? Certainly not. As has already been pointed out, the economic situation in Sweden would most undoubtedly have been still worse if prices had been allowed to fall as they did in countries that kept to the old gold parity. The fatal spiral of deflation was avoided in Sweden, i.e. a fall in prices leading to losses and a heavier burden of real debt, this in turn necessitating forced sales and the suspension of business, with a resultant further fall in prices, and this again leading to fresh liquidations. There is nothing to indicate that the "weeding-out" that this would have given rise to in business would have been either natural or healthy.' (Bertil Ohlin, *The Inadequacy of Price Stabilization* in *Index* (Svenska Handelsbanken, Stockholm), Dec. 1933, p. 264.)

[1] Wholesale prices remained reasonably stable, but if security prices had been included, the index would have shown a strong upward tendency in the United States in 1925–9.

of promoting a continuity of values. The majority of the Group, however, hold that it would be more satisfactory to consider the relationship between prices and costs (and all data bearing on this relationship) rather than prices alone. There is, of course, this common ground: both views agree that the huge price-movements which the world has experienced since the War were undesirable, and that political and economic stability alike call for a technique which will prevent them in the future.

The majority of the Group define continuity of values in terms of a stable relationship between prices and costs—that is, a stability of the profit margin. Such a stability would make easier the normal working of the price system. Where there is over-production or inefficiency, profits fall off, thus acting as an inducement to reduce production or to introduce improved methods. Where there is under-production profits are attractive enough to draw capital to that field. Where production is reasonably efficient and related to consumption, the existing situation is maintained.

'The individual business man, looking ahead and making plans, wants to feel sure that if his judgement as to demand and as to what his competitors are doing is correct, and that if his methods are efficient, he will make a profit, and that his profit will not be eaten away owing to action by the monetary machine. At the same time it is highly desirable that profits should not be so large as to tempt over-development in a particular field. Further, it is a necessity of the economic system, if progress is to be orderly, that the individual producer who does make mistakes or is inefficient should not be protected from the results of his folly owing to monetary fluctuations. Hence the stress on the monetary policy being so directed as to preserve a proper relationship between costs and receipts throughout industry generally.'[1]

This price-cost relationship is a dynamic one, and is constantly being affected by two sets of factors. On the one hand, the introduction of technical improvements is tending to lower costs and so to increase profits; on the other, wage increases—and during a period of prosperity the tendency is for wages to rise—are raising costs and lowering profits. If the two do not cancel out, and the savings due to improved technique outstrip the increase in wage bills, the profit margin is growing larger.

On the whole it seems fairly safe to say that technical achievements have often outrun the rise in wages. How far wages do rise depends on a large number of extraneous factors, social, political, and economic. The power of the wage-earner to secure for himself a

[1] *Monetary Policy and the Depression*, p. 80.

substantial share of the fruits of increasing knowledge varies from country to country. In some he is better organized than in others. His status and right to combine with his fellows differ according to the legal and social framework in which he finds himself. In Great Britain his position is a fairly strong one; on the other hand, statistics show that in the United States 'profits were outstripping wages, and that the wage-earner was not gaining a proportional share of the fruits of this very rapid development'[1] in the years immediately preceding the depression.

But increased productivity unbalanced by increased wages gives rise to special problems. If prices do not fall, temporary opportunities for the employment of fresh capital may be created which in the long run will not be justified. Further, there may be sharp rises in security values, in due course leading to a break. This is what was happening in the motor industry in America before 1929, for example. Thus the preservation of the proper relationship between prices and costs may involve a slight fall in prices in so far as increased money wages are failing to compensate for increased productivity. It is important that goods should get distributed and consumed, and it is either through higher money wages or through lower prices (or possibly through something of both) that goods do get distributed. In a world in which debts weigh so heavily, there is something to be said for helping the debtor and the wage-earner, and therefore for favouring higher wages as against lower prices. Nevertheless, once we admit the possibility of profits getting inflated (and so making for future difficulty) through economies due to improved technique, one must allow some downward trend in prices whenever there are signs that the wage-earner is not getting his fair share of the benefits of economic progress. Under what circumstances this may happen will depend on experience.

A theoretical alternative which has sometimes been envisaged is that the general level of money wages should be stabilized, and the fruits of improved productive processes made available to the worker through a falling cost-of-living index. Whatever the theoretical possibilities of such a policy, in practice it would seem to be too extreme. On the whole it may be said that a slowly rising level of money wages is socially desirable. This has been the position during the whole of the pre-War period; it would seem to be psychologically more satisfying than a fall in the cost of living, and it would help to avoid friction. Moreover a stable wage level would mean that a rise in the wages of one industry would call for a compensating fall in the

[1] Ibid., p. 7.

wages of other industries—a situation which would seem to bear the seeds of much trouble and of all the economic losses which industrial strife involves. It is important that wages between industries should vary so that the flow of new entrants be directed towards the more remunerative occupations. This necessary variation has been secured in the past by rising money levels of wages, and it would appear to be desirable that it should so be secured in the future. In the social framework of to-day it is possible that any attempts to stabilize a general level of wages will be followed by greater rigidity as between occupations, considerable industrial strife, and an inability to make readjustments. Rising money wages would best seem calculated to draw labour from one industry to another. And, from the standpoint of history, rising money wages have been, and still are, the order of the day, even though the process is held up or temporarily reversed during depression.

The extent to which an increase in the profit margin due to improved technique[1] may bring about dislocation must vary according to particular circumstances, and is largely bound up with the requirements of a country for new capital and the rate of capital accumulation socially desirable. In Russia, for example, rising prices and the increasing investment in capital goods might well be justified in that the opportunities for reasonable development are many and obvious, while at the same time in the United States the consequences of a spurt in activity may be disastrous. In Great Britain the dangers are less than in the United States; but at least we must allow for a hypothetical possibility that a sudden burst of enthusiasm may make for the development of a new industry of quite unjustified dimensions. Stability of the price-cost relationship should help to act as an insurance against any such serious misjudgements, while at the same time imposing no depressing influence on economic activity as a whole.

What are the specific data for authorities to consider? The movements of costs and prices in relation to each other show themselves in many ways, though not all of them are useful for the purpose of determining policy. Indicators that point to the fact that depression is in full swing are valueless as warnings that there is a danger of depression; what are needed are indicators which react quickly and point to initial disturbances and so put the monetary authorities on their guard. Governor Strong once gave a list of indicators in the light of which Federal Reserve Policy was guided. This was in 1926,

[1] Though this increase may often be illusory: greater technical change should call for a greater rate of obsolescence.

when the United States was, of course, on the gold standard. This list includes:

Various indexes of money rates, employment, production, and prices.
Sales of retail stores.
Sales of stocks of wholesale dealers.
Savings-bank deposits.
Changes in rents.
Changes in wages.
Movements in funds about the country.
Foreign exchange rates.
Business profits.
Volume of building.
Failure statistics.
Report of car loadings.
The consumption of electrical energy.
All the crop statistics.
All the foreign trade reports.
Inventories.
Speculations.
Bank clearings.
Changes in deposit and loan accounts of banks.

These indexes have a varying importance under different circumstances. Indexes of prices, of wages and of money rates, and of profits all have a direct bearing on the price-cost relationship. The real difficulty is one of interpretation. A merely quantitative interpretation is dangerous; proper judgement for monetary purposes would require to know not merely what movements had taken place in the indexes themselves, but also the reasons for changes in the main components. This emphasis on the qualitative, as opposed to the merely quantitative, interpretation is very necessary. Every index deals with economic activities of one sort or another, and a monetary authority anxious to secure an accurate estimate of economic reality with a view to deciding what its policy should be must make allowance for their individual peculiarities. It is not enough to see what an index is doing; we must have knowledge of why it is doing it.

Apart from indexes of prices, costs, and profits, a number of other statistics have their importance in showing how far economic development is taking a healthy turn or not. Figures of stocks in hand and of the volume of sales show the working of the distributive process. Especially important are any data which indicate how the flow of new investment is changing, since the price-cost relationship, if it is to remain in equilibrium, must be supported by a steady flow of

new capital development rightly directed. If this flow slows down, unemployment occurs and there is a danger that a fall in output and prices will gather momentum. Further, it is important to remember that mistaken investment in the present may mean a slowing down —and consequent disorder—in the future.

Booms on the Stock Exchange or in land values are danger signals which cannot be ignored. Both are creating artificial valuations; if these artificial valuations are to be sustained, the monetary authority will have to allow costs and prices to get out of gear. If they are not sustained, the process of liquidation and the losses incurred will act as a drag on economic activity, and the shock to confidence will slow down the pace of new development. As has constantly been emphasized, once a boom gets out of hand some depression is inevitable, and the most that monetary policy can do is to try to make the liquidation as orderly as possible.

Price indexes are more useful in indicating that there is disturbance and change than in measuring the size of the change. For this reason especial importance attaches to the relative movements of different indexes; for example, that of consumers' goods and of capital goods, or of manufactured goods and of raw materials. The first sign of an unhealthy expansion of credit (and this may take place through the increased velocity at which an existing volume of credit is circulating) may very well show itself not in the familiar wholesale and cost-of-living indexes but in a rise in the price of capital goods—machinery, building products, and the like.

There are omissions in Governor Strong's list. For example, there is no mention of population. The reason for this omission is clear enough. On the face of it the authorities in charge of a Central Bank are concerned with short-run phenomena; they are considering what they should do to-day to prepare for to-morrow. At the most they are looking towards normal seasonal changes, towards crop movements in the summer or a drain of payments in the autumn. But an effective monetary policy must concern itself with long-run problems as well. Economic historians have attempted to distinguish between cyclical and secular price-movements over, say, fifty-year periods. The trend of prices deserves attention, and its significance can only be seen in the light of the increase of population and of the rate of growth of the media for making payments. Other factors, such as the progress of technical improvement and invention over a long period of years, will also have to be taken into account.

Thus it would seem that a Central Bank, whether it be guided mainly by price indexes or not, must still make a full and compre-

hensive survey of the whole economic field before it can decide whether more money or less, cheaper money or dearer, is desirable. All information may be relevant; it should be interpreted qualitatively and not merely quantitatively; the movements of different price indexes relatively to each other are especially significant.

One further point is especially worthy of emphasis. The need for more and better statistics has constantly been emphasized by economists. The Macmillan Committee[1] expressed the view that we should aim at obtaining 'a complete inventory of the economic life of the community under its several aspects in such a form that we could cross check the accuracy of our information by being able to work out to the final totals from more than one direction' (para. 405). It tabulated at some length statistics which it felt to be necessary and desirable. It went on to stress the view that action in regard to the collection of statistical information was urgent.

'We attach very great importance to this part of our recommendations being carried into effect. For the completer information, which would thus be put at the disposal of those responsible for deciding policy, may prove to be an indispensable preliminary to their being able to work out practical methods of management for attaining the objectives of the monetary system. To put on a more scientific basis our acquaintance with the fundamental facts and trends of our economic life, and to replace empiricism by ordered knowledge, might prove to be the greatest step forward that it lies within our power to take towards raising the economic well-being of our country to the level which the technique of production would allow, provided only that our machinery for collective action was such as to facilitate the whole of our productive resources being brought into fruitful activity.' (Para. 425.)

In short, in order to secure economic stability the monetary authority, given the essential prerequisite of full and accurate information, must make its judgement in the light of the general economic situation.

Thus the distinction between the conceptions of a constant price level and of a stable price-cost relationship refer to method rather than result. A stable price-cost relationship would keep prices stable except for a slight tendency to let them fall in cases where the social structure of a country tends to keep money wages stationary while productivity is increasing. Such a fall—if it restricts industry at all—is preventing an undesirable boom and not bringing about depression. It does not increase the weight of debt, and the slight downward movement can easily be foreseen. It thus goes far to

[1] Cmd. 3897 of 1931.

achieve the objective of those who advocate a constant price level, though interpreting the method with rather greater elasticity.

And both methods aim at a continuity of values. As life is continuous and men make contracts in money intended to be implemented in the future, it is essential that money should conform to the assumption inherent in the contract that it will retain (broadly at any rate) a stable purchasing power. Unless this is the case a lease, a mortgage, a debenture, and a fixed salary scale become wildly speculative ventures and the life of an entrepreneur who bears the residuary effects of all such contracts is necessarily a nightmare.

CHAPTER VI

POWERS AND LIMITATIONS OF THE FINANCIAL MACHINE

So far the discussion has dealt in a fairly general manner with business fluctuations. The next step must be to consider the financial machine, the weapons it has at its disposal for controlling the economic situation, and the circumstances under which they may be applied. It must be remembered that the methods and their possible efficiency will be dependent on particular conditions in individual countries.

Financial structures vary, as also do the specific problems with which monetary authorities may be faced. In some ways the most significant distinction between various systems lies in the degree to which they enable all resources to be profitably utilized, that is in the extent to which they reduce the necessity for liquid balances within the system. The larger the volume of liquid resources which have to be kept available and unemployed, the more cumbersome becomes the task of management and the more insensitive is the monetary organism. A highly developed and specialized organism (such as that centred on London) is especially sensitive and has at the same time greater power of controlled action. Other financial organisms respond much more slowly—and the explanation of this is to be found not merely in the monetary structure but in matters of industrial organization, politics, and geography.

In Great Britain we find a Central Bank with wide powers and the ability to exercise a considerable measure of control. On the other hand, the problems are rendered more difficult in that British finance has to concern itself with the needs not only of British and world industry but also with those of a commercial centre which plays its part in financing world trade. The financial system of the United States is more elaborate and more unwieldy; the Federal Reserve authorities have smaller powers of control because the commercial banks use rediscounting facilities as a matter of course and not as a safety valve in case of emergency, while the Call Money rate is to some extent independent of the Federal Reserve rate. Here, again, there are not one but many tasks; grain crops must be moved, manufacturing industries must be supplied with capital, bursts of speculative activity on Wall Street raise special problems. In France, in contrast, the machinery is less powerful but the problems are simpler. The Banque de France is debarred from open market operations; on the other hand, it has no Wall Street to deal with, and

does little to finance world trade. Its function is largely to facilitate payments from one part of France to another.

The weapons at the disposal of financial authorities for controlling the economic situation may be discussed under the following heads: Bank Rate, open-market operations, changing reserve ratios, the lending policy of commercial banks, the new-issue market, publicity. It will be noticed that the first three—and perhaps even the fourth—are dependent on the Central Bank. The interaction between fiscal and credit policy is left for consideration in a further chapter.

1. *Bank Rate*

Bank Rate is the rate of interest at which a Central Bank is always prepared to discount bills of a certain agreed type. Through the use of these discounting facilities the volume of credit can be adjusted. Adjustment may be necessary either because of changed business requirements (seasonal or otherwise) or because of an increased demand for cash due to financial crisis or credit stringency. In the case of Great Britain the method of adjusting credit through rediscounting is only used when circumstances become abnormally difficult. The Bank of England is 'a lender of last resort'. 'Whatever bank or banks keep the ultimate banking reserve of the country must lend that most freely in time of apprehension, for that is one of the characteristic uses of the bank reserve, and the mode in which it attains one of the main ends for which it is kept.'[1] The Bank is always prepared to lend, but at a rate which definitely discourages borrowers; it will help the money market—at a price which discourages the market from availing itself of this help except in an emergency, or on a special occasion when balance sheets presenting an appearance of ultra-liquidity are thought to be desirable. On the other hand, in the United States rediscounting facilities are regularly made use of. There the underlying conception is that as trade expands the number of bills will increase and, with a proportion of these being rediscounted, the volume of credit will keep pace and expand. Discount rates 'shall be fixed with a view of accommodating commerce and business'.[2] In short, the theory is that the flow of money shall increase or fall off as the volume of business varies. Superimposed on this, and almost in conflict with it, comes the *further* conception that the authorities can *control* undue activity by positive counteracting operations.

While some might claim certain advantages in the automatic tendency towards expansion in the United States as increased trading

[1] Bagehot, *Lombard Street*, 1896 ed., p. 66.
[2] Section 14 of the 'Federal Reserve Act'.

brings with it a greater quantity of bills which can be rediscounted, there are disadvantages which have to be set on the other side. The powers of control of the Federal Reserve system are very seriously weakened.[1] When the Federal Reserve Banks raise rates and sell securities in the open market in an attempt to control a boom, the commercial banks can always relieve the position by rediscounting on an increased scale. Similarly, when depression is acute they can neutralize the attempts of the Federal Reserve system to flood the market with cheap money by reducing the volume of their rediscounts instead of increasing their advances.[2]

Difficulties of this sort do not arise in Great Britain. An increase in bills does not involve an increase in rediscounts, and the commercial banks are never in debt to the Bank of England. There is no automatic increase or falling off in the volume of bank credit, but only change in its composition and velocity. When there is a change in volume it must be due to the deliberate decision of the Bank of England itself. Bank Rate—as we have seen—is a rate which has direct application only under special conditions, though on most occasions various other interest rates follow its movements fairly closely. At times, however, short-term money rates get completely out of touch with it. If the Bank wants to see a stiffening of rates it will have to sell securities in order to make its Rate effective. If it wants to see lower market rates, purchases of securities may have to precede reduction in Bank Rate; without this a reduction might make it profitable for the Money Market to discount bills direct at the Bank.

The effect of a rise or fall in interest rates is to change the cost of borrowing to business men; thus they will be offered an inducement to hold up or increase new enterprise. If rates rise the volume of economic activity grows smaller, the flow of money lessens, and decreasing activity brings pressure of a greater or less degree to bear on prices. Further, a rise in rates—assuming that there is no element of panic—has international repercussions of a very specific kind, since balances and/or gold will tend to be attracted from abroad owing to the higher returns available.[3]

2. *Open-market Sales and Purchases*

As the previous pages suggest, it is impossible to discuss the mechanism of Bank Rate in a manner which does not touch on the

[1] These remarks, and what follows, refer to the pre-Roosevelt period; it would be premature, with so much in the melting-pot, to attempt to assess the significance of recent American developments.

[2] See below, pp. 144–6.

[3] See below, pp. 124–6.

sales and purchases of securities by the Central Bank. It may be well at this stage to explain this phenomenon shortly. In Great Britain and the United States the deposits of the public with the commercial banks bear a direct relationship to the deposits of the commercial banks themselves with the Central Bank. ('Deposits' is used to cover both current accounts and deposit accounts; and 'Central Bank' covers the Federal Reserve system of the United States.) In this country the proportion is conventionally assumed to be about 10 to 1.[1] Any action which the Central Bank takes to increase or decrease the deposits of the commercial banks with it will accordingly be reflected on a magnified scale in the deposits held by customers at the commercial banks. Thus, if the Bank of England buys £100,000's worth of securities from a man who banks at Lloyd's Bank, the man will find his account at Lloyd's increased by £100,000, and Lloyd's Bank will find its account at the Bank of England also increased by £100,000. Further, Lloyd's will now be free, having regard to the proportion it maintains, to create new credit by lending direct to customers or by buying securities. The credit thus created will tend to be distributed by the operations of the Clearing House among all the Clearing Banks. The debit balance at the Clearing House will reduce the cash balances of—in this case—Lloyd's, and will increase those of others. In their turn the other banks will create new credit which gets diffused. At the end of the operation £1,000,000 of credit has come into existence. The reverse process happens when the Bank sells securities instead of buying them. If it sells £100,000's worth of securities, £1,000,000's worth of credit is in due course cancelled. Thus through open-market operations the Bank of England has control over the volume of credit outstanding, though the reactions discussed are not immediate.

It is important to consider not merely the volume of credit, but the type of credit that is created. Given an increase in cash of £100,000, the banks will increase *advances* by not more than, say, £500,000 because they tend to keep that item of their assets at 40–60 per cent. of their liabilities. They will increase other assets—bills, call money, and so on—in conventional proportions. Taking the banking system as a whole, the result will be something as follows. Assets will be made up to £100,000 (credit with the Bank of England), £500,000 (advances to customers) and £400,000 (bills, call-money, and so on)—total £1 million. Liabilities will consist of the deposit of the customer who has sold securities to the Bank of England, £100,000 and £900,000 further deposits created through advances and the purchase of other

[1] But see p. 74.

assets—total £1 million. Thus, although the £100,000 has proved the basis of £1 million of new deposits, only half of these deposits owe their origin to fresh advances. The sum total of these effects would be: (i) a smaller net increase in effective credit than appears at first sight, and (ii) a downward tendency in bill and money rates.

It is clear that the use of Bank Rate and of sales and purchases of securities by the Central Bank cannot be dissociated from each other. A movement of Bank Rate by itself might to some extent prove ineffective; security sales or purchases by themselves might either make the Rate ineffective or force an increase. Nevertheless, within narrow limits the two methods may prove alternative, and on this account it is important to compare them and contrast them.

First, a movement of the London Bank Rate makes an immediate impression within a few minutes. Further, by virtue of established custom it at once alters (at all events under normal conditions) the rates of interest paid for a considerable part of banking accommodation throughout the country, thus immediately affecting the remunerativeness of trade and industry slightly in the case of current transactions, but more in so far as prospective transactions are concerned. Open-market operations, on the other hand, are much less spectacular and affect, in the first instance, money market conditions.

Second, though leaving the Bank Rate untouched, open-market operations may increase or decrease the fringe of unsatisfied borrowers from the banks. Thus the volume of bank advances may be affected while the price of banking accommodation remains untouched and bill rates fall slightly as the banks acquire liquid assets *pari passu* with making advances. A change in Bank Rate, on the other hand, does affect the price, and need not affect the volume, of advances assuming that there is a fringe of unsatisfied borrowers. During a period of acute depression, however, the volume of advances is likely to be directly affected, since there is no fringe of unsatisfied borrowers. Thus a rise in the Rate will reduce the volume of advances still further, while a fall may increase it, or at least prevent it decreasing as fast as it would have done otherwise.

Third, open-market operations, since they affect the demand for the particular types of security in which a Central Bank is operating, change directly short-money rates and less directly the long-term rate of interest. The change in short-money rates may be taken for granted, but in the case of long-term securities the effects must not be over-stressed. During depression the price of those securities in which banks deal tends to be insulated. Government bonds may rise,

but it is not safe to assume that a high price for such securities inevitably means a high price for industrial debentures, though in due course there will be some repercussions. The immediate effect on the yield of long-dated industrial securities may be small.

Fourth, the power of a Central Bank to buy or sell securities is limited by the supply of suitable securities, especially if it is not prepared to incur losses through buying securities at a high price and selling them at a lower one. The importance of this fact depends, of course, on the conditions of the moment, and hardly needs elaborating.

Thus it may be concluded that a banking system such as we have in Great Britain, armed with the powers of changing its rates and dealing in securities, has almost unlimited control over the volume of money in the hands of the public as long as there is an ample supply in the market of the type of securities which it is ready to hold.

But there is no indication as to the purposes for which this money will be used. The directions in which money may flow depend on the commercial banks rather than on the Central Bank. The commercial banks are faced with a choice—they can either advance money direct to borrowers, or they can in their turn buy securities. While they prefer advances as they give a better yield, there may be a scarcity of suitable borrowers. Money issued by way of loan is pretty certain to enter the stream of effective purchasing power, while money issued by way of the purchase of securities may in certain circumstances lie idle, since all that has happened is that the public has been tempted to part with a holding of securities to a bank in exchange for a credit balance. It does not in the least follow that this credit balance will be used by its owners to purchase goods and services. On the other hand, it is likely that bank advances will be used to buy goods and services of one kind or another.

The significant difference between these two types of operation is that the purchase and sale of securities can be performed on the initiative of the banking system, while borrowing calls for the initiative of the borrower. If there is no fringe of unsatisfied borrowers, the banking system is forced to employ any additional money in ways which do not necessarily add to the effective stream of purchasing power. Such is the position in a time of acute depression. The Central Bank reduces Bank Rate and reinforces its action by buying securities. There are no credit-worthy unsatisfied borrowers to whom the banks are prepared to lend; hence they in their turn buy securities. But little of this new money helps to increase the

volume of economic activity. In short, the banks cannot put more money into circulation; it is the public who do that; the banks can only refrain from stopping them.

Thus the position during depression may be summarized as follows. In spite of extensive purchase of securities by the banks the flow of effective purchasing power remains unaffected. The price of 'eligible' securities has been raised. Consequently eligible borrowers (the Government or Town Councils, for example) can borrow cheaply, but this does not necessarily apply to ordinary industry as the risk premium is much greater in a time of depression. A large number of people are holding inactive deposits, and will tend to keep them inactive as long as depression lasts. When the upturn comes these inactive deposits will begin to circulate with greater and greater velocity and may accelerate revival to an unfortunate extent unless countervailing measures are adopted.

While open-market operations can play a very useful part in effecting a lowering of interest rates or in allowing an increased proportion of an existing demand for loans to be satisfied, they may be dangerous when their main effect is to pile up a quantity of stationary deposits which may move at the wrong moment. These may present the Central Bank with the difficult task of trying to reduce the volume of money in the hands of the public without at the same time bringing revival to a standstill.

The general conclusion as regards credit policy must be that to preserve stability the banking system requires both the weapon of open-market dealings and that of manipulation of the short-term rate of interest; that if applied quickly and continuously both may have considerable effectiveness in preventing the development of disturbing influences; but that once an extravagant expansion or contraction of the total flow of expenditure is allowed to develop, both may prove ineffective.

3. *Changing Reserve Ratios*

As we have seen, two features of the English system combine to give the Central Bank a greater measure of control over the total volume of money in the hands of the public than prevails in most other countries. These are, first, the fact that Joint Stock Banks are never in debt to the Bank of England and the other elements of the money market not normally so; second, the traditional constancy of the proportion maintained by the commercial banks between their reserves and their deposit liabilities. It follows that the Central Bank has almost absolute control over the volume of the balances

kept with itself by the other banks, and that changes in this volume are reflected almost automatically, though not perhaps quite immediately, in the total volume of money in the hands of the public. But the latter point must not be over-stressed. The 10 to 1 ratio is only an approximation, and varies within limits, especially at times when the return on certain types of asset is so low that the banks are unwilling to expand to the full for fear that they will force down the return still lower. Thus, between July 1933 and April 1934 the percentage of coin, notes, and balances with the Bank of England rose from 10·4 to 12·0; since then it has fallen.

This consideration lends interest to a third feature which has sometimes been suggested; that it might be convenient for the Central Bank to operate on the total volume of money by procuring an agreed modification in the reserve ratio of the ordinary banks rather than by expanding or contracting its own purchases of securities. The Macmillan Committee[1] favoured action on these lines:

'We make the suggestion, therefore, that as to a variation within certain narrow limits, the banks should accept the advice of the Bank of England as to the average figure at which they should keep their reserve balances—the Bank indicating to them from time to time the advisability of a change (which probably should be quite small on any one occasion). The advantage of this technique, as compared with open-market operations, would lie in the fact that the Bank of England is somewhat narrowly limited by custom in the classes of securities which it can buy or sell, whereas the effect of an alteration in the reserve proportions of the joint stock banks could be spread over the whole of the assets of those banks.

'Whatever ratio of reserves be fixed as suitable it is in any event most important that it should be rigidly adhered to by the banks. For the power of the Bank of England to control the aggregate volume of credit in the country by means of open-market operations and other measures essentially depends on the rigidity of this ratio.' (Para. 370 (6).)

Another variant of this suggestion is that the banks (as in America) should keep a larger percentage reserve against their current than against their deposit accounts, so that a transfer from the latter to the former would necessitate an increase in the average reserve ratio, and conversely. It has even been suggested (in accordance with a plan proposed by the Federal Reserve experts for their own country) that the reserve should be made to vary in some defined way not merely with the magnitude of the deposits but with their recorded velocity of circulation.[2]

[1] Cmd. 3897 of 1931.

[2] 'The committee recommends, therefore, that the reserves required to be carried by each individual member bank be determined, first, on the basis

If there were a shortage of securities on which the Central Bank could operate, the case for changing reserve ratios might well be overwhelming, but in fact the problem does not seem to be a pressing one. The distinction between current and deposit accounts, as regards the second aspect of the proposal, is a difficult one to draw, and in America it has not proved easy to enforce the two reserve ratios in a satisfactory manner. It is doubtful whether an automatic control of this sort would be superior to a deliberate and conscious control. Important as proposals such as these may be under particular circumstances, they are rather in the nature of useful technical devices; they do not in themselves provide a solution for any urgent problem.

4. *The Lending Policy of Commercial Banks*

The methods so far considered deal merely with the total quantity of credit, and the possibility of controlling it in order to divert it to productive uses. In essence they are undiscriminating; they do not distinguish between one form of productive or speculative use and another. Apart from the quantitative aspect, some form of qualitative regulation would seem to be essential if monetary policy is to preserve any far-reaching stability. While it can play little part in times of slump, as a brake on excessive and ill-co-ordinated expansion qualitative regulation would seem to be a useful and attractive expedient. There is much room for improvement in the methods of bank lending, and bankers are still too much governed by such considerations as the security offered and their past practice in regard to particular borrowers. They could scrutinize more critically than they do the purposes for which the money they are lending is to be used, and this would be very much facilitated if there were elaborate pooling of information between the competing Joint Stock Banks. If they were to equip themselves with technical knowledge in regard to different branches of industry, they could play the role of advisers

of the total volume of deposits held by the bank irrespective of whether they are held by city or country banks or whether they are classified as time deposits or demand deposits, and, secondly, on the basis of the actual activity of these deposits, that is, the actual dollar volume of charges which are made to these accounts. . . . This formula will eliminate all of the classifications of deposits at present used to determine required reserves. . . . This formula, therefore, by basing reserve requirements directly on the volume and activity of the deposits of the individual member bank, places each member bank on an effective parity with respect to the type of banking business in which it is engaged, and achieves in practice those distinctions which theoretically should but actually do not result from the present classification of cities and deposits for reserve purposes.' Report of Committee on Bank Reserves in *Nineteenth Annual Report of the Federal Reserve Board*, 1932, pp. 274–5.

and critics much more effectively, and over-expansion in certain particular industries—so conspicuous a feature of past economic history—would be avoided. It might be well to emphasize that this need in no way involve the banks in 'taking the initiative' in industry and trade.

The chief difficulty which any qualitative regulation of credit must face is that of competition among the banks. But bankers have always recognized that they are in control not merely of competing enterprises but of social institutions with wide responsibilities, and it is difficult to believe that the necessary element of co-operation is unattainable. From the banks' own point of view qualitative regulation of credit would help to save them from losses or frozen assets.

5. *The New-Issue Market*

It is important to remember that the relationship between the banking system and those responsible for the conduct of industry is not an all-embracing one. The banks provide only certain types of credit: they do not provide long-term capital, for example. Unless the picture includes Issuing Houses, the Stock Exchange, company promoters, building societies, and similar institutions, it is incomplete. Of these the most important undoubtedly are Issuing Houses and the Stock Exchange. The latter is important in that 'leave to deal' is a privilege which is necessary for all borrowers on any scale. The former provide the normal machinery for placing large issues, and on their decision a great deal must depend.

The influence of the banking system over new issues is two-fold: indirectly, the desire of borrowers to come forward for a loan at a given moment will depend on the monetary conditions prevailing, while the desire of lenders to take up long-term loans will be affected by the short-term alternatives available; directly, the monetary authorities will be in touch with the Issuing Houses and the Stock Exchange and will be able to make their views known. The efficacy of the control will depend entirely on the way in which the placing of new issues is organized and on the manner in which those responsible for this essential part of economic activity carry out their task. The efficacy of such control will depend on the general conditions governing the placing of capital. In a country such as Great Britain the wishes of the Bank of England and of the Treasury are as a general rule respected. The difficulty of any formal sanction for an issue is that the granting of such a sanction appears by implication to carry a measure of positive approval, and is liable to be construed as a

favourable expression of opinion on the soundness of the objects which the loan is designed to forward. This difficulty could to some extent be avoided if the authorities were prepared to take the public more often into their confidence as to the reasons which make certain policies desirable. On the face of it there is no particular difficulty about influencing the new issue market provided the other elements in the financial machine are working in harmony. But there is no doubt that the banking system will find difficulty in exercising any substantial measure of control over the tempo of economic activity if contrary policies are being pursued by the various parties (including the Treasury) involved in the process of financing. The use of monetary policy to smooth out business fluctuations presupposes a co-ordinated policy. If this is lacking we shall go on running the risk of over-development, illustrated so graphically by the over-development of the automobile and constructional industries in the United States in 1927–9, or the recapitalization of the Lancashire cotton-spinning industry in 1919–20.

6. *Publicity*

The efficacy of the central monetary control is to no small extent conditioned by the understanding and sympathy with which its various actions are received by the money market and the public. It follows that some type of publicity is needed through which the control may make clear its views. Skilful publicity can also combat the growing tendency of political and sectional business interests to interfere with the discretion of the Central Bank.

Three methods of publicity are nowadays adopted by Central Banks: (1) periodical publications of statistical matter—with or without written interpretation—relating to the various aspects of financial and business activity, possibly taking the form of monthly bulletins; (2) statements issued through the Press (when considered desirable) to explain the reasons for a particular action on the part of the central monetary authority; (3) 'inspiration' of the market through selected intermediaries who may be either members of the market or the Press. The Bank of England is known to use this last method more or less extensively.

Each of these methods has its uses. The monthly bulletin—which has been furthest developed by the Federal Reserve Board and has been adopted in the last few years by the Bank of England in the form of a statistical summary—is not of course a means by which current action by the Central Bank can be explained to the market. It is rather a means by which the market may be enabled in some degree

to follow the mind of the Central Bank by having at its disposal the statistical information which the Bank thinks it worth while to collect for its own guidance. It is of particular value in this respect if it contains information which is not otherwise obtainable and which is of cardinal importance to the true appreciation of the monetary position of the centre concerned—for example, figures of foreign balances.

The other two methods both serve the same object. In theory 'inspiration' is potentially the more efficient of the two, at any rate as an instrument for habitual use, since information can be conveyed by it which could not for one reason or another be given publicity, whilst skilled journalists in personal contact with the executive officials of the Central Bank may be expected to present the case for any action by the Bank more effectively and convincingly than could the Bank itself within the limitations of a formal statement. In practice, however, it presents certain possibilities which are dangerous and undesirable. 'Inspiration' involves the giving of certain information which has a commercial value, and as such gives a hold to those 'inspiring' over those 'inspired'. From the commercial point of view it is much more important for a paper to be inspired than independent in its financial policy, and consequently the City Editor tends to be chosen for his ability to get 'inspiration', which may mean, in fact, his unwillingness to take an independent line. The process of favouring the sympathetic with exclusive information may be rare, but it is a possibility which cannot be ignored.

It may be suggested, however, that still greater use might be made of publicity. This applies especially to the case of Great Britain, where the objectives of Bank action are only too often shrouded in mystery, and give rise to speculation and conclusion of the flimsiest sort. The mind of the Bank might well be interpreted to a wider public than that of the 'market', and the public should be left in no doubt as to what is the point of view of the Bank of England and what is speculation of the editor of the financial pages of a daily newspaper.

7. *The Efficacy of Control*

The machinery at the disposal of the monetary authorities for controlling economic development has been discussed at some length, but its value in preserving economic health and the resulting continuity of values has yet to be assessed.

It is important to draw a distinction between normal conditions and abnormal conditions, those of primary and secondary recession. To take the case of depression, there may be, for example, a slacken-

ing in activity and an increase in unemployment which has not proceeded very far, and while to some extent the ill-effects of inactivity are making themselves felt, there is as yet no panic or crisis. On the other hand, depression may have reached a critical stage; production has fallen off, the national finances are threatened, prices are quite unremunerative; there appear to be few opportunities for profitable investment for the business man; economic upheaval has undermined confidence in the future and perhaps is threatening the fabric of society itself. The two sets of conditions are in essence different, though the former, if unchecked, may lead to the latter. It must then be the primary task of credit policy to try to prevent what might be described as a normal depression developing into an abnormal one. 'Normal' depressions—if they may thus be described—are probably inevitable in a world which changes rapidly under the influence of new inventions and new desires, and perform the function of forcing supply from one channel into another. But no purpose is served if they are allowed to grow to such a stage that most forms of production—whether desirable or undesirable—begin to appear unprofitable.

If monetary action is to be successful, the authorities must be in a position to act quickly and firmly; and past history often appears to suggest that the authorities are waiting on events instead of trying to anticipate them and control them. Action must be quick and well-timed if it is to be decisive. Further, the possibilities of working through changes in rates and dealings in securities would be very much strengthened if forces could be brought to bear to prevent the artificial financing of redundant plant and the direction of capital to undesirable quarters. The function of the banking system when depression makes itself felt must be a dual one: it must help to secure the liquidation of undesirable portions of the economic system; at the same time it must try to sustain the general level of activity and encourage compensating influences elsewhere. It would be a fruitless task to sustain the general level of activity while at the same time keeping in being the maladjustments which are constantly making for depression. In regard to maladjustments a source of great difficulty is the inefficient firm with a long purse derived from under-distribution of profits in the past. Dividend equalization accounts, as they are often applied to-day, are not always in the long run in the interests either of shareholders or of the public generally.

Yet this is a consideration of remedies, after the evil has happened. The most effective way of preventing a slump is to prevent the occurrence of exaggerated booms, and the over-development in

specific directions which brings maladjustments into being. This is a difficult task for a banking system to undertake, even when the system is as highly developed and as easily controlled as that in Great Britain. It is probable that it will never be completely successful without a greater element of co-operation and of qualitative control of credit. Manifestly it is ridiculous to have to attempt to control a boom due to *particular* causes by slowing down general economic activity—and that is what, in the absence of any form of qualitative control, Central Bank action involves. The prevention of unwise lending calls above all things for co-ordinated knowledge.

In conclusion, it is probably fair to say that effectively-armed monetary authorities (and this assumes that the commercial banks are conscious of what is happening over the whole field and are not merely competing with each other blindly, and also that there is a common policy covering Treasury and New Issue activities) should be in a position to control the general situation as long as it remains fairly normal, provided that international complications are absent. On the other hand, there is no reason to suppose that bank action alone can restart activity once collapse has occurred; probably the most it can do is to pave the way for revival.

Abnormal depression and collapse is the result of a widespread loss of confidence in the future, and involves an unwillingness on the part of investors to start new development or take any risk. Secondary deflation is in full swing: the falling-off in new investment leads to a falling-off in general activity, and the fall in general activity in its turn makes new investment seem quite hopeless. Credit policy alone cannot create a flow of new investment. If steps are to be taken to organize a demand for capital goods, action going far beyond the province of the banking system must be envisaged. It is in the light of government action that the problem must be approached.

CHAPTER VII

CREDIT POLICY AND PUBLIC FINANCE

So far the possibility of reducing business fluctuations has been considered in the light of action by banks and lending institutions. The implied corollary of this is that the fluctuations with which we are dealing are fluctuations of a limited magnitude, and that business men will react to changes in the terms of borrowing and the increase or curtailment of credit facilities. Such assumptions do not always hold good. In the first place, monetary policy is not confined to credit policy alone; there is also fiscal policy to consider, for the influence of Government finance on economic conditions may be considerable. Secondly, such severe stoppages of economic activity may occur that credit policy proves ineffective.

Conditions of economic collapse—the 'abnormal' depressions of the years following 1929, or of certain periods in the nineteenth century—are clearly beyond the control of credit policy pure and simple. For business men the opportunity to get money on more favourable terms may prove an inducement when minor dislocations only have occurred, and where no secondary recession has as yet made its appearance. But money at low rates of interest offers few inducements when activity has slowed down so much that opportunities of profit are limited in the extreme, and the prospects of an improvement remote. The borrower hangs back until he feels more confident about the future—that is, until revival is well under way. For his part the lender, while willing to lend at low rates of interest for short periods, is not happy about locking his money up when he feels that by waiting he may find more remunerative opportunities of safe lending. The offer of cheap credit is a vain one as long as the good borrower prefers to wait until he can see what the future has in store.

The prospects, further, do not depend on economic considerations alone. The certainty that people will want food, drink, and shelter, health and the comforts of life, amusements and pleasing trivialities, is a stabilizing factor which should add assurance even when the outlook is unpromising, but as soon as there is a lack of these essentials and amenities—when economic difficulties are at their most acute stage—political difficulties are superimposed. In some countries these may remain well under control; in others they may go to extremes and culminate in violence. In any case uncertainty is magnified, and business men who might be inclined to go ahead with their plans,

since they deal in essentials for which there is bound sooner or later to be a demand, hang back on account of the danger of political upheaval.

But one 'good borrower' still may remain—the Government. Even since before the War the tendency has been for Government financing to bulk more and more largely in a country's affairs. With the advance in material well-being, social services have come to play an enhanced part in national life. The legacy of the War has been an enlarged burden of indebtedness, the management of which gives scope to variations in policy. Economic activity generally has become more and more dependent on Government policy, to some extent in Great Britain, but far more elsewhere.

A Government is on its own account an investor on a large scale, and can afford to take a long-range view at a time when the ordinary company must be preoccupied with its next balance-sheet and not with its prospects over a period of years. When other borrowers neither have confidence nor can command it, the Government can still borrow at the very low rates of interest prevailing during depression, and can play at least a limited part in preparing the way for a better state of affairs. These considerations point to the duty of a Government doing its utmost to reinforce an expansionist financial policy with an expansionist investment policy on its own account.

1. *Government Investment as a Substitute for Private Investment.*

It is tempting to envisage a world in which, as the demands of private investors fall off, the Government steps into the breach. The contractors and builders formerly engaged on building offices or rich men's houses would be clearing slums or building schools. Electrical engineers who built turbines for private companies under normal conditions would be working for semi-public bodies like the Central Electricity Board when there was no longer a demand for turbines for private industry. Town halls would be ordered instead of factories, museums instead of banks. As one demand falls off, the other takes its place. In due course, when private industry recovers, orders from public authorities slow down. The picture is over-simplified, since the limits of Government action must be set by the character of each depression, but the principle is relevant.

But it is only partly true that Government investment is a substitute for private investment, as long as the normal demarcation between the two is accepted. Are we prepared to see the Government stepping into the field of the entrepreneur and starting and operating business enterprises for profit which he himself would operate under

normal conditions ? Whatever the position might be under a coherent philosophy which looked to the Government taking over an increasing share of the field now covered by private enterprise, there are few arguments which can be put forward in favour of the haphazard extension of Government action into the field of general profit-earning activity during depression.

This line of demarcation leaves the two forms of activity in distinct, or semi-distinct, compartments. While to a large extent materials such as those used in building are necessary equally to private or to public investment, this is far from being the case every time; the building of roads—or any other sort of Government activity—does not increase the demand for specialized machinery, for example. Given this fact, it must be admitted that there are limitations to what can be done without temporarily diverting labour from one form of activity to another, or temporarily raising certain prices out of relation to others, and that Government investment can never prove a complete substitute for private investment as long as it does not follow identical lines. To what extent it is either possible or desirable to concentrate public works programmes in times of acute depression is discussed below.

2. *The Economics of Public Works*

By public works must be understood enterprises of a capital nature undertaken by or on behalf of a public body. The subject has been attracting increasing attention during recent years and has been discussed at some length in *Monetary Policy and the Depression*.[1] In Great Britain local authorities and other public bodies had already been carrying out a large volume of such works in the years preceding 1929. The same was true of many continental countries. After the beginning of depression many countries abroad accelerated their public works programmes. The significant thing about capital works is that while expenditure upon their construction can be spread over a short period, their cost can be met over a period of years. They are a useful form of monetary expansion because they have positive merits in addition to the purely negative merit of being expansive; they add to a nation's assets and perhaps to some extent its taxable capacity, while an ordinary income deficit does not.

Their theoretical importance has already been suggested. They can form a substitute for private investment in times of acute depression when the flow of private investment has dwindled. The case for them rests fundamentally on a common-sense fact which is only forgotten

[1] Chapter IV and Chapter V, pp. 64–7.

or lost sight of because economic life is nowadays so complex—the fact that idle savings, like idle labour, cannot be preserved through time. Both must either be used or else run irretrievably to waste. Theoretically, therefore, the case for concentrating any necessary public works—that is, any expansion of public capital assets—in times of depression, when there are idle savings and idle labour, may be regarded as generally accepted.

This case is reinforced if the converse is considered in the light of what happens if public works are being expanded during a period of prosperity when there are no idle resources to be employed. Given the absence of idle resources, the activities of the public authorities will be in direct competition with those of private investors for money, for labour, for materials, for sites. Prices, wages, and interest rates will rise until demand is choked off, and if the public authorities are pertinacious in carrying on, the demand withdrawn will be that of private investors. In the meantime those who remain will have made their calculations on the basis of the rapid upward movement, and the opportunities for mistaken investment will be increased. With the rise in prices, activity may lead to boom and then to slump. When the slump comes those private investors who were forced to postpone activity at the earlier stage will feel doubtful about the future and will no longer be willing to initiate or extend the enterprises they have in mind even though prices and money rates have fallen. Thus the converse strengthens the theoretical case for public works during depression. It shows that such works undertaken in prosperity may be a very strong disturbing factor.

But a theoretical approach of this nature does not touch on the specific setting in which public works must be carried out. The practical questions which arise are sometimes obvious, sometimes less obvious but more far-reaching. In every case the enterprise embarked on must be considered worth while; at the beginning men and equipment must be mobilized for the job, and at the conclusion they must be demobilized; while they are being used for the task in hand they are not available for any other work; during the period of their employment the men, at all events, will consume more goods and in greater variety than they would consume if idle; and for each enterprise individually, or for a series of enterprises taken together, finance must be provided in one or more of various possible ways. A less obvious question is the scale on which a nation proposes to execute public works over a period of years: that is, to what extent it contemplates adding to its public capital assets and to the volume of its national debt.

As it stands, the theoretical argument only applies to a minimum programme of public works. Admittedly, in so far as absolutely necessary public works are concerned, they should as far as possible be executed in times of depression. The only question is a technical one—how far such necessary works can be spread between one period and another. There is no validity in the argument that works should be postponed from times of depression 'till we can afford them' during prosperity. But this does not dispose of the views of those who might hold that for a long period of years to come we can only afford the very minimum of public capital expenditure. Granting that every one is agreed that this necessary minimum should as far as possible be concentrated during a slump, the whole question is yet to be considered as to how far the sphere of capital expenditure should be widened altogether.

The first case which may be considered is that of works normally associated with public authorities which would prove remunerative in the ordinary 'balance-sheet' sense. Here, again, there is no room for a difference of opinion. There is every argument for a forward policy during depression. But it must be admitted that the amount of such works can seldom be large, since the most general characteristic of public services is that they are of such a nature that it is socially difficult or undesirable for them to be run at a 'balance-sheet' profit.

Next, we may consider capital works not profitable in the narrower sense, but profitable to the community at large. A new road or a new bridge may more than pay for itself; for example, if it creates new rateable values and increases the value of neighbouring property or if it increases the profits and taxable capacity of those who make use of it. If a bridge saves a long detour, the transport costs of those who use it may be substantially reduced. Similar considerations would apply to a new water-supply system or any facility of a similar sort. It does not of course follow that any road or any bridge will add sufficiently to the community's wealth; the point is that in so far as they do add sufficient to justify their cost they would seem to be justified as public works. Therefore, going outside a 'balance-sheet' interpretation, we still find a type of public work to which no objection can be taken.

We can therefore agree that all public works which are absolutely necessary or are profitable to the community at large should be extended as far as possible during depression and slowed down during prosperity. There are, however, certain assumptions which must be brought into discussion at this stage. The first assumption is that the country in question is a creditor country. For debtor countries

the position is much more difficult, and a large number of outside factors will have to be brought into consideration. The second assumption is that the Government is not on the point of putting through a debt-conversion scheme; factors of such a nature might make a temporary hold-up desirable. The third consideration is that construction costs should be at a sufficiently low level. The latter two conditions are realized at a particular point during the downward movement of business activity and would seem to dictate when the real pressure should come. How great this pressure can be must depend on how far programmes can be accelerated or slowed down at will, and this in turn depends on the thoroughness and thought with which plans can be prepared in advance.

But the sphere of public works so far has been kept very narrow, and it is doubtful how far more than a very slight acceleration can be based on activities absolutely necessary or profitable to the community at large. The great bulk of public works that have to be considered—at all events in a developed country—are concerned with amenities, general utilities, and the large-scale anticipation of programmes of social welfare which might otherwise have been postponed to the future.

Here what must be borne in mind are questions of public policy and social conscience. The case for a gigantic programme of slum clearance is one thing if we are all agreed that slums are an evil which must be swept away in the next few years, and an entirely different thing if we take the view that they are a necessary evil which we must be prepared to tolerate for many years to come. It is probable that much of the discussion which has centred on public works has no direct bearing on public works as such at all, but is the reflection of differences of opinion as to social policy. The heart of these differences of opinion lies in the problem of whether in general we can afford more museums and good working-class dwellings, and not in the problem of whether we should pull down slums and build museums at a given moment. If we are agreed that these must be built some time, there can be no doubt whatever that depression is the appropriate time for such activity, since to postpone action to a period of greater prosperity entails the risk that Government over-expenditure will bring on a boom.

While it is outside the present argument to consider the wider implications of social policy it is highly relevant to try and estimate what would be the cost to the community of a far-reaching capital expenditure policy during a period when men, equipment, and money are alike unemployed. More men employed means to a certain extent

(though admittedly it may be a small one) an increased demand for consumers' goods, an increased tendency to disperse stocks, an increased profitability of commerce and industry. But these advantages may or may not outweigh the cost to the community. Given idle resources and idle savings, it is never, in a modern state, a question of whether none of the savings shall be used to support unemployed workers but entirely a question of *how much* shall be applied for this purpose. From our present point of view, unemployment relief is also a variety of non-productive public work, but the difference between unemployment relief and so-called capital undertakings is that the former absorbs a smaller proportion of the total of unutilized savings than the latter. Men can be quite idle for, say, a pound a week, but it requires three to five times as much to employ them in making roads or building swimming-baths or laying out parks. To what extent is the non-remunerative use of this larger fraction of idle savings justified?

The calculation involved must come in two stages. First of all an attempt must be made to estimate how many men will be employed from the expenditure of a given sum of money, and secondly, an estimate must be made of how much this sum is reduced through the saving on unemployment insurance and through the greater yield in taxation which follows on this expenditure.

Mr. Keynes has made calculations covering this ground:[1]

'It is often said that it costs £500 capital expenditure on public works to give one man employment for a year. This is based on the amount of labour directly employed on the spot. But it is easy to see that the materials used and the transport required also give employment. If we allow for this, as we should, the capital expenditure per man year of additional employment is usually estimated, in the case of building for example, at £200. But if the new expenditure is additional and not merely in substitution for other expenditures, the increase of employment does not stop there. The additional wages and other incomes paid out are spent on additional purchases, which in turn lead to further employment.'

At this stage Mr. Keynes breaks off his argument to stress the fact that it is based on the assumption that there are unemployed resources in the country. Clearly it would not be valid if this were not the case since under those conditions 'additional purchases would be mainly reflected in higher prices and increased imports'. In circumstances of depression, however,

'this would be true of only a small proportion of the additional consumption, since the greater part of it could be provided without much change of

[1] J. M. Keynes, *The Means to Prosperity*, Macmillan, 1933, pp. 9–14.

price by home resources which are at present unemployed. Moreover, in so far as the increased demand for food, resulting from the increased purchasing power of the working classes, served either to raise the prices or to increase the sales of the output of primary producers at home and abroad, we should to-day positively welcome it.'

Mr. Keynes now resumes the original line of argument.

'Nor have we yet reached the end. The newly employed who supply the increased purchases of those employed on the new capital works will, in their turn, spend more, thus adding to the employment of others; and so on'.

Unfortunately this process cannot go on *ad infinitum*:

'For at each stage there is, so to speak, a certain proportion of leakage. At each stage a certain proportion of the increased income is not passed on in increased employment. Some part will be saved by the recipients; some part raises prices and so diminishes consumption elsewhere, except in so far as producers spend their increased profits; some part will be spent on imports; some part is merely a substitution for expenditure previously made out of the dole or private charity or personal savings; and some part may reach the Exchequer without relieving the taxpayer to an equal extent. Thus in order to sum the net effect on employment of the series of repercussions, it is necessary to make reasonable assumptions as to the proportion lost in each of these ways. . . . It is obvious that the appropriate assumptions vary greatly according to circumstances.'

He goes on to suggest figures for the number of people thus employed.[1]

'My own estimate, taking very conservative figures in the light of present circumstances, makes the multiplier to be at least 2. It follows that the loan-expenditure per man-year of employment is, not the figure of £500 with which we began, but £100. Since, however, I am anxious not to overstate what will be a sufficiently striking conclusion anyhow, let us take it at 1½, i.e. that two men employed by loan-expenditure lead indirectly to the employment, not of two further men, which represents my own belief, but of one further man. I do not think that any one who goes through the detailed calculation can bring it out at less than this: which means that additional loan-expenditure of £200 on materials, transport, and direct employment puts, not one man to work for a year, but—taking account of the whole series of repercussions—one and a half men. This gives us a figure of £133 as the amount of additional loan-expenditure required to-day to stimulate a man-year of employment. But let us, in order to give ourselves a further margin of safety, base our argument on the figure of £150. This answers, most conservatively, the first of our two questions. Next consider the magnitude of the relief to the Budget. For purposes of

[1] In the *New Statesman and Nation* of 1 Apr. 1933 Mr. Keynes, in an article entitled 'The Multiplier', amplified the description of his technique.

broad calculation the average cost of a man on the dole is usually taken, I think, at £50 a year. Since, on the basis of the above calculation, a loan-expenditure of £3,000,000 will employ at least 20,000 men for a year directly or indirectly, it follows that it will save the dole £1,000,000. Here is one-third of the expenditure already accounted for.'

Mr. Keynes goes on to point out that the new income thus generated will in part at any rate be subject to taxation, though he admits that there will be some time-lag before it appears as revenue. He argues that the increased revenue will be of the magnitude of £500,000.

'Thus the total benefit to the Exchequer of an additional loan-expenditure of £3,000,000 is at least £1,000,000 plus £450,000, or, in round figures, £1,500,000, i.e. a half of the loan-expenditure; or two-thirds of it, if we were to take the multiplier as 2. . . .

'If we apply this reasoning to the projects for loan-expenditure which are receiving support to-day in responsible quarters, we see that it is a complete mistake to believe that there is a dilemma between schemes for increasing employment and schemes for balancing the Budget—that we must go slowly and cautiously with the former for fear of injuring the latter. Quite the contrary. There is no possibility of balancing the Budget except by increasing the national income, which is much the same thing as increasing employment.'

While the general line of Mr. Keynes's argument would appear to be correct, it must be remembered that he is making assumptions in the absence of evidence on certain important points. First, it is not known what proportion of their additional expenditure the newly employed devote to imported goods. Second, it is uncertain how far the new expenditure will—directly and indirectly—lead to new employment and not to more intensive work for those already employed. Third, it is doubtful how far there are unemployed resources available in all industries to such an extent that there will be no rise in the price of materials. Fourth, there is no estimate of the proportion of the money spent on public works which would be directed to the purchase of land. This last point is especially important. Money spent on sites is not spent directly on wages and need not necessarily appear in the stream of active purchasing power. A project such as that of the new bridge at Charing Cross would involve very large payment indeed to the owners of the sites.

If the amount going to property is large, it is impossible to say that the expenditure of such and such an amount of money will bring a given number of men into employment. A loan expenditure of £3,000,000 will employ at least 20,000 men a year directly or indirectly (and will automatically pay for more than half of its cost) only if the

public work projects are such that every £200 spent employs at least one man directly in building, in transport, or in the making of materials. This is Mr. Keynes's initial assumption, which he does not discuss, and it is a big limiting assumption.

The problem of financing public work need give rise to no difficulties. If the short-term market supply of Treasury bills seems excessive—the money can be raised most satisfactorily through long-term borrowing by Government or local authority, extensive open-market purchases of securities being used to force down the rate of interest and keep down the cost of financing. It is, of course, important that the borrowings in question should not be permitted to force up interest rates. They need not do so.

The conclusion to be drawn from the argument discussed above at some length is that considerations of cost and finance on the whole strengthen (though not to the extent Mr. Keynes suggests) rather than weaken the case for an extensive public works programme in so far as the new works undertaken can effectively be concentrated in a period of depression without overlapping into periods of boom. In so far as they do overlap the case for them is very much weakened, and the result is that especial emphasis is thrown on the importance of the technique of planning in advance of carrying into effect works of this sort. Properly planned, the greatest utility will be served and the greatest economies made through such undertakings being pushed as far as possible during a period of depression.

These arguments must to a very large extent be interpreted in the light of conditions in particular countries. Perhaps they have least application to debtor countries which find themselves in desperate straits owing to a surfeit of bad finance during a period of apparent prosperity, though this conclusion does not inevitably follow. In most creditor countries—the United States and France for example—public works during depression are a matter of course. The circumstances of Great Britain are peculiar in that a large volume of public works was being executed in the decade previous to 1929, and useful opportunities appeared limited and plans had been exhausted. Britain has the further difficulty that its population is reaching its maximum and shifting its location in directions which it is difficult to foresee. Even in this country, however, programmes of slum clearance and relief of overcrowding have been urged which as far as possible should be concentrated during depression.

At the same time it might be well to stress the fact that a large-scale programme, if it is to have its full effect, should have the way prepared for it by proper explanation. If there has been a general demand for

economy, public opinion feels a not unnatural exasperation at the sight of large expenditure on works which bring no immediate financial return, and can in many cases be represented as luxuries. This applies with special force to those who have had their incomes severely cut by that very Government which is spending money so lavishly. And this resentment is increased by the belief that a State, like an individual, should cut down expenses in bad times, when in fact it would be truer to say that the State should cut down its expenses in good times and increase them in bad in order to even out the changes of expenditure on the part of its private citizens.

There is, of course, no evidence as to the scale on which public works expenditure can be increased or decreased from time to time. This, again, must depend on organization and circumstance. But, stating the position in purely negative terms, it is clear that for Governments or local authorities in creditor countries to cut down capital expenditure during depression is definitely anti-social, retarding recovery, and depriving workpeople gratuitously of their means of livelihood. This is not to say that it will always be possible to increase expenditure to any substantial extent, but it should always be possible to avoid reducing it at such times on grounds of 'economy'.

To sum up, as far as possible public works programmes should be kept at a minimum during prosperity and increased during depression. The real issue between big or small public works programmes lies farther back and only partly falls within the sphere of economics. The conception of the part to be played by social services in the life of the community varies from individual to individual. If the State is to see its services—public education, municipal housing, and others—extended it is eminently desirable that the capital preparation for this extension should take place during a slump.

3. *Budgetary Policy and the Business Cycle*

Banking policy cannot bear fruitful results if it is being neutralized through the Government pursuing a contradictory course in financial matters. Government policy involves a transfer of income; it may be a transfer from people who will spend to people who will not spend, or vice versa. It may thus either strengthen or weaken the monetary authority in its attempt to quicken or slow down the pace of economic activity. If banking policy and budgetary policy are pulling in opposite directions the result can only be confusion. The most sensitive and efficient monetary system will find itself unable to control a boom if huge budgetary deficits are constantly adding fuel to the fires of speculation. Conversely, during a depression all the

efforts of Central and commercial banks to coax some activity into a torpid economic system may be doomed to failure, if at the same time the Government is determined to cut down expenditure to a minimum, to increase taxation, and to add to the rigours of deflation. If easy money is to be effective, Government policy must also play its part.

Owing to the necessity of maintaining expenditure at a more or less fixed level Governments tend to increase taxation rates in times of depression, and to lower them—if at all—in times of prosperity. Ideally the process should be reversed. This cannot be carried very far, if the necessity of balancing a yearly budget be admitted. But something can be done in regard to sinking fund arrangements, so that debt is repaid quickly in times of prosperity, and slowly or not at all in times of stress. This process could be extended so as to make substantial repayments of debt in good times,[1] reducing these and giving a corresponding relief in taxation when a depression was approaching. It might very well be argued that the State should approach its fiscal problems from a much wider angle than that of securing a balance over a twelve-month period, and proposals for five-yearly budgets have been advanced. Devices of this sort certainly merit very serious attention even though under existing circumstances a great deal of preparation might be necessary before such policies became politically acceptable. But there are means by which a budget surplus could be carried in prosperity and deficit in depression without allowing them to appear as tempting or alarming as in the past. One possible method is to finance public works out of revenue in prosperity and out of borrowings in depression—a book-keeping change which might be helpful. Another method might be to establish self-supporting funds similar to the Unemployment Insurance Fund which automatically have surpluses in good times and deficits in bad times without affecting the national accounts. If the income-tax payer saw abundant surpluses accruing year after year without any reduction

[1] It is sometimes objected that debt repayment during prosperity may have an undesirable inflationary effect. It is difficult to accept this argument. Prima facie, the effect is nil—taxation has transferred sums of money and reduced the quantity of securities in private funds in the process; the quantity of money and credit outstanding is the same. If the taxpayer and the security holder were identical, there would be no change. In so far as this is a transfer from people who would spend to people who would save—as is likely to be the case—the effect is a healthy one in that it increases the volume of genuine saving. Only in so far as the transfer is from those who would save to those who will spend are there likely to be inflationary influences—and on balance this will not be the case. In any case the heavier taxation has made new investment appear less attractive.

in his burdens, he would be very strongly tempted to raise his voice. Nevertheless, the lessons of adversity should have taught him that that would be preferable to an increasing rate of tax on a decreasing income when depression appears.

Another possibility which must be considered is that of reforming taxation in such a way that the tax machine can be used to slow down or speed up the rate of new development. One method of approach might be to free company reserves in whole or part from income-tax. How far such a measure would actually increase demand for capital goods during a period of acute difficulties is an open question. The measure might be more effective if the exemption of company reserves from income tax were so framed as to favour companies who adopted a forward development policy during the slump, the exemption being narrowed down or even abolished when prosperity returned. But it is not easy to reach any very specific conclusion on a point such as this.

On the other hand, the possibility of using the tax machine as a corrective of the trade cycle merits more attention than it has received in the past. It is quite conceivable that the same revenue could be raised in either of two ways; one, so as to discourage the investment of money in capital goods; or two, so as to encourage it. Though the total revenue might be the same, the specific taxes would be different. An inquiry into the effects of different sorts of taxes on the way that money is spent might bring valuable results. Such an inquiry should also cover local taxation. The incidence of local rates driving industries away from defined areas is an illustration of the part that a particular form of tax may play in changing the shape of development, and the derating of industry a recognition of this fact.

Apart from the detailed aspects which we have discussed, there is the fundamental question which always arises during an economic set-back, how far—if at all—is an unbalanced budget justified? The question raises obvious difficulties in that the answer must clearly be different for different countries. Unbalanced budgets can hardly be of help in themselves to an insolvent central European State, whose chief problem may be that of avoiding political disintegration. But if the subject of involuntary inflation of the more extreme sort is set aside, there still remains the question whether a creditor power should not deliberately incur an excess of expenditure over revenue. Here, again, the answer must differ according to the position in which a country finds itself. The state of a public opinion is one factor—and perhaps the major one—which must be taken into account; the actual debt situation is another. In the United States, where debt was low and was being rapidly amortized before 1929, the case for balancing

the budget is not so strong. On the other hand, a balanced budget would seem more desirable in a country where the debt is already heavy and where the prospects of a greatly accelerated rate of amortization during prosperity are poor.

It can, however, be said that in itself a balanced budget brings a creditor no nearer to prosperity, except in the important matter of confidence under the present condition of public opinion. Certainly the excess of revenue over expenditure should be kept as low as possible and there is every reason for attempting to reduce taxation in anticipation of a possible increase in revenue rather than to wait for the increase to materialize. Balancing the budget may even counteract the effects of an easy money policy.

But this qualified verdict does not touch on the much bigger questions with which proposals for unbalancing the budget are sometimes associated. What would be the effect of, for example, abolishing all income-tax till prices have risen to a desired level, or of repaying a portion of the National Debt in printed notes?

It will be noticed that the essence of such proposals is that they should be drastic. They are shock tactics intended to bring about a given result in as short a period as possible. If this is the case it is important to examine this result not only in relation to the shock level of prices attained but also in relation to their effect on the structure of industry.

The position is that taxes are remitted or Government borrowings repaid in paper. The man who benefits is the big taxpayer or the big holder of Government Loan, either of whom finds his bank balance increased. He may leave his bank balance untouched. In this case the measure is ineffective in the same way as open-market operations may be ineffective, and the position will be unchanged. But this is an unlikely hypothesis since we have postulated that these inflationary measures are in the nature of shock tactics. It implies that the beneficiaries are going to expect something to happen, and in the circumstances it is at least fair to assume that they will do something with their money. They may use it in one or more of three directions: first, on consumption of goods for themselves; second, on buying capital goods of a normal sort and employing more labour; and, third, buying existing property or commodities which are likely to appreciate in value for the purpose of selling them again. Further, if the export of capital is not under rigid control, they may transfer their balances abroad.

If the money is spent in either of the first two directions the effects are likely to be somewhat similar to those which occur under more

normal circumstances of revival. Unfortunately it is more than likely that the money will be expended in the third direction, that is, that it will be hoarded. If so, it will not be used to promote an increase of real activity, but for the speculative purchase of existing valuables. Consumption is not likely to rise very much, while if the money is to be used for making a profit much the easiest way of doing so is to speculate in commodities. Increased employment due to new industries being set up is at best a remote and not a primary consequence. The consequence, then, of this new spending is a rise in land values, raw material, and so on; consumption goods remain where they were.

Under these circumstances the producer of consumption goods finds that his receipts are stationary, while the prices of the materials he uses have gone up. His profit margin is decreased. Any desire he may have to expand will be discouraged. While it is true that in the long run the producers of raw materials will enjoy increased buying power the immediate effect of the shock tactics will have been to cause dislocation. While an inflation which makes itself felt in speculation may do a great deal to bring fortunes to the speculator, its effect on business activity proper—that activity which employs workers and pays wages and salaries—will be remote and perhaps definitely discouraging. What has happened is that the wrong prices have risen. Instead of a steady increase in all prices or an increase in sales, the prices and sales of manufactured goods are stationary while those of raw materials have risen sharply. While in certain circumstances a rise in the relative prices of raw materials may be desirable, in others it may only bring about new price dislocations instead of correcting old ones.

Therefore the case for any form of inflation is strongest if it can be shown that the speculative demand will be limited and the normal phenomena of trade revival reproduced. What is wanted is not a spectacular rise in prices, but less unemployment, more capital development, larger wage bills, and a gradual rise of prices from their lowest depths as a consequence of increased activity. A shock inflation is not calculated to help these tendencies.

The effect of these considerations is to suggest that any policy for restoring the position must be judged in terms of employment and of the demand for capital goods. From this standpoint it will be seen that a budget deficit—provided it is not too large—or an extensive public works programme may play an important part; but their significance lies in the fact that they do help to promote more normal forms of demand and are the most effective way in which an

expansive policy can be made effective while avoiding shock tactics. A successful policy must aim at coaxing an increase in economic activity, and not at bringing about sweeping upward valuations in the desirability of holding certain types of transferable capital goods, of which raw materials in which there is a speculative market are the best examples. Another aspect may also be considered. Even though there is a large number of unemployed resources, the flow of new goods coming on to the market can only be increased at a limited rate. If the flow of purchasing power increases very rapidly and outstrips the increase in the flow of goods coming on to the market, a large but temporary jump in the price of these goods will follow. When the flow of goods catches up with the flow of money the resulting fall in prices may have a depressing effect which may lead to further difficulties. If friction is to be avoided monetary policy must aim at trying to keep the pace of recovery as steady as possible.

4. *National Policy and Private Investment*

It is difficult to see clearly what part Government policy can play in the direct stimulation of private investment. This difficulty is due to the fact that—except under the hypothesis of a Socialist State—Government interference of this sort is irresponsible in the sense that it is not the Government that bears the brunt or gets the benefit of any steps which it may promote. Fundamentally, it is the weaker firms who desire assistance, and the stronger ones who can do without it. The helping of weaker firms as against their stronger competitors may very obviously lead to harmful effects. It is for this reason that opportunities for useful assistance on the part of the Government seem so limited.

Even where this particular difficulty does not arise because the Government is prepared to help an industry as a whole in such a way that both weak and strong benefit, rival industries may find themselves in conflict. In a sense most industries are competing against each other, and consequently the possibility of drawing a line and saying that thus far and no farther will official help be given is a difficult one. One form which help might take is in aiding and encouraging schemes for the reorganization of a particular industry. Further, for certain types of enterprise the Government may find itself in a position to stimulate activity by providing special borrowing facilities in connexion with large-scale capital works. But under existing conditions it is difficult to see how governments can do much—apart from a few negative gestures—to stimulate directly private enterprise into a more active frame of mind.

CHAPTER VIII

SPECIAL PROBLEMS OF GREAT BRITAIN

UP to this point discussion has been devoted to the nature of business fluctuations, and to the part that monetary policy might be able to play in preventing or correcting such movements in business activity. Monetary action was considered both from the credit and the fiscal standpoint. The next stage must be to examine the present position of Great Britain in such a way as to relate the general problem to the existing situation.

The background against which the special problems of Great Britain have to be considered has changed in many important respects. Before the War Britain's prosperity depended upon her financial supremacy and even more upon the tremendous part played by her main exporting industries. Since the War these exporting industries have definitely been a waning influence. Industrial development overseas, and increased competition from other manufacturing countries, has led to the loss of markets which were once looked upon as more or less the exclusive preserve of this country. To some extent the growth of economic nationalism which has so undermined Britain's position as a world exporter is to be traced to the disturbance of the War, and a development of new industries in those countries which were then cut off from their normal source of supply. But it is also due partly to the fact that improved agricultural methods demand fewer people on the land, so that an increased population must be given employment in the towns, and partly to a more general desire for self-sufficiency and diversification of economic activity in order to make a country better able to resist both military aggression and business fluctuation. As a result that part of British industry dependent on foreign trade is proportionately much less important to-day than before the War. This decline in Britain's export industries has called forth changes in British policy. The abandonment of free trade, the reciprocal trade treaties, and the new agricultural marketing policy are all evidence of an attempt to secure some re-adjustment to the new conditions in which export trade is playing a smaller part.

Another change of far-reaching importance is shown in the growth of contracts and similar arrangements which involve fixed money payments over a period of years. This is shown most spectacularly in the growth of a huge volume of national and local Government indebtedness. But it is paralleled by the extension of industrial

indebtedness in terms of fixed interest. Under uncertain conditions there is always a tendency to fight shy of equities, and to demand fixed interest securities in their place. This was especially noticeable in the case of overseas lending, but is also seen in the increasing number of debenture and preference shares which were issued in the years after the War. This volume of fixed payments is further paralleled by the growth of obligations of other kinds which in fact are difficult to modify. The great extension of social services has led to the growth of a large expenditure connected with them. It would be impossible to reduce this expenditure without giving up activities which have now become a recognized part of our national framework. Further, the wage structure has on the whole become more rigid, partly on account of the development of unemployment insurance, and partly owing to the extension of trade union and other influences over wages. Increasing organization not only makes operatives more able to resist reductions, but also helps employers to resist increases.

All these changes have been reflected in Britain's industrial structure. The failure of the export industries has brought with it the problem of the depressed areas, and the post-War unemployment problem. The development of new commodities—wireless, gramophones, and motor-cars are examples—has not succeeded in compensating for decline elsewhere. There is the further difficulty that the demand for commodities of this sort is likely to be a fluctuating one. A further compensating influence—though again it has not succeeded in taking up the slack—is the tremendous development which has gone on in the distributive machine, and in services generally. The numbers employed in distribution have gone up by some 50 per cent. in the last ten years, but in spite of that the unemployment problem has remained a pressing one.

Lastly, there is a further factor to be taken into account—the decline in the rate of growth of population in this country and also elsewhere. In this country the population is likely soon to cease to increase, and when this occurs it will mean the deflection of demand more and more towards the fluctuating industries which serve the desire for minor luxuries. The decline in the growth of populations abroad may not be so pronounced, though it is substantial in many countries, but it does emphasize the fact that Britain's old export industries are likely to go on declining, and if new British exports are to be built up to take their place, they also will have to concern themselves with popular luxuries rather than with the major necessities.

1. *The Main Problems*

Out of this general description certain specific features emerge which deserve attention in some detail. These new features may be classified roughly under four heads: first, the vastly increased debt burden; second, the diminished international financial supremacy; third, certain defects in the machinery of home investment; and, fourth, the special problems presented by the depressed industries. After a few preliminary remarks each of these questions will be examined at greater length.

First, the debt problem. Great Britain emerged from the War with a national debt far larger and proportionately heavier than that of any other country. She had helped to finance not only her own share of the War but that of many of the Allies. The existence of this debt must be reckoned with for many years to come, and must have a direct bearing on questions of general economic policy.

Second, the diminished financial supremacy. Britain's preponderating financial position in the pre-War years has become an accepted commonplace; after the War London's leadership was challenged by New York. This country lost her supreme position partly through the War and partly through the over-valuation of the pound in 1925, which paradoxically enough had been undertaken in order to preserve this financial supremacy. Since the break-down of the gold standard, however, there is ground for believing that London may regain at least some of her financial leadership. Recent events in the United States have weakened the position of New York and definitely suggest that American financial interests are more likely to look to the domestic position than to the world at large. It is, of course, impossible to say whether this will prove a permanent tendency or not, but it is at least probable that it will continue for a considerable time to come. The position of Paris has in the past not led to many constructive efforts, and has been weakened by recent events. There is no reason for thinking that French financial policy will be strong enough or positive enough to make Paris a rival to London. In short, London was very strong before the War, weak after the War, and likely to be stronger in the immediate future. Her influence may yet prove decisive once more in the international monetary sphere.

Third, defects in investment machinery as far as home industry is concerned. It emerges from the Macmillan Report that 'speaking generally, the exceptional merits of the City of London lie in the facilities given by the short-term money market for the employment of home or foreign funds; in the financing of trade and commerce, also, both home and foreign; and in the issue of foreign bonds as

distinguished from the financing of British industry'.[1] This is to be traced to the fact that British commercial power preceded British industrial power. We were a trading nation before we became industrialized; and when our industries did develop, it tended to be through the efforts of individual financiers with money at their disposal who did not have to depend on the financing of the City of London. These financiers are disappearing as capital and management become divorced; but financial machinery has not kept pace with the change and filled the position left vacant by the disappearing entrepreneur-financier.

Fourth, the depressed industries. Of these cotton, coal, and shipbuilding are the most conspicuous examples. Their unfortunate position is due to over-developed capacity following on the War and to overvaluation of their capital assets. This inflated position has not been rectified because the banks were so deeply involved during the boom that they have been unwilling to cut their losses. Consequently, Britain's depressed industries have enjoyed financial support which they would not have commanded in any other country, and this support has tended to preserve the evils from which they are suffering. With unemployed and under-employed capital have gone unemployed and under-employed operatives. The problem of the depressed industry has become a social as well as an economic problem.

2. *The Debt Problem*

The following figures show the weight of the National Debt.

	Total National Debt Service.[1]	*National Income (net) of inhabitants of the U.K.*[2]	*National Debt Service as a Percentage of National Income.*
	(£ millions)		
1924	357	3,586	9·9
1926	379	3,684	10·3
1927	379	3,887	9·8
1928	369	3,849	9·5
1929	355	3,996	8·9
1930	360	3,938	9·1
1931	322	3,499	9·2

[1] Including Interest, Management and Expenses, and New Sinking Fund. Statistical Abstract for the U.K.

[2] As estimated by Colin Clark, *The National Income*, pp. 63, 70. These figures exclude internal transfers of income due to existence of the Debt itself.

Roughly, interest and sinking fund on the National Debt are equal to one-tenth of the national income, and would have become much

[1] Cmd. 3897 of 1931, para. 376

heavier in depression if sinking-fund appropriations were not greatly reduced. Even when the conversion operations of the last few years are taken into account it must remain a heavy burden.

Since the Debt charges are fixed in terms of money, an obvious inference from this is that the larger the nominal national income, the less would be the real weight of Debt charges. This would seem to point to the desirability of a high level of money prices, wages, and salaries rather than a low level, in fact to a level which would substantially reduce the real weight of past obligations. On the other hand, the desirability of such a state of affairs once attained is not an argument for rash or ill-judged measures to attain it, nor in particular for a large, sudden, and ill-balanced rise in certain prices, those included in the wholesale indexes in particular. What is wanted is a scale of prices and costs balanced at a high level, but this is very different from having the higher level without the balance. Therefore, any conclusion that a higher scale of prices and costs is desirable in this country on account of the national debt burden must be tempered by the consideration that progress towards such a scale must be slow and careful. On the other hand, this does point to the danger of any steps (such as the adoption of the monetary parity at too high a level) which would permanently make the fixed weight of debt unduly burdensome.

It is true that there is a theoretical alternative. The weight of debt can be reduced by total or partial repudiation, by a special tax on the incomes of debt holders, or by devices of this sort. No doubt all these methods have their uses in the case of countries in the last extremities of collapse. But in relatively normal times the arguments against any forced method of reducing past burdens are overwhelming, and need hardly be recapitulated here. Government credit is a national asset which is worth preserving under all except the most extreme circumstances. Ruling out the arbitrary methods just mentioned, since the possibilities of partial conversion are limited, the only way to lighten the debt burden is the scaling-up of the money price and income structure.

3. *Financial Structure*

The Macmillan Committee have described at some length the change in London's financial structure since the War.

'This pre-war system depended on the extreme liquidity of London's claims on the rest of the world. In 1913 the sterling bill was the foundation of the system; a large part of the outstanding volume of such bills represented acceptances on behalf of foreign clients; and consequently any

measures taken by the Bank of England to curtail the volume of sterling bills resulted within a few weeks in the maturing of claims by London on the rest of the world. The Bank of England chose, therefore, mainly to depend on its power to contract the volume of acceptances by its control of the money-market, and was content, having this power, to economize in the amount of its other liquid resources.' (Para. 347.)

The Committee then go on to contrast the post-War position of London, with its tendency to borrow short and lend long. They suggest that 'London is now practising international deposit banking, as distinct from international acceptance business and the deposits associated with this, on a larger scale than before the War' (para. 349 (iii)). They go on to contrast the effect of a rise in Bank Rate before and after the War.

'A rise in discount rates in the pre-war money-market functioned mainly by calling in our claims on the rest of the world through the contraction in the volume of our acceptances. A rise in discount rates to-day is more liable to function in part by increasing our liabilities to the rest of the world through the attraction of short-term funds from abroad. Thus, the ease with which we can for a time meet claims on us by attracting precarious short-term deposits, while it is certainly a great convenience, may also be a danger unless we avail ourselves of it only with the greatest moderation and prudence.' (Para. 349 (iv).)

Hence

'all this may be summed up by saying that there is much more risk than there used to be of our financing long-term investment by means of attracting short-term foreign funds of a precarious character, and thus gradually slipping into a less liquid position than is desirable. This may result in our having to maintain short-term rates over a long period at a level inappropriate to domestic requirements in order to retain the precarious foreign funds which we have inadvisedly employed in a non-liquid way.' (Para. 350.)

In the light of these observations the Committee came to a significant conclusion: that this country should be in a position to hold a larger volume of liquid assets which could be released in a sudden emergency to avoid the necessity of a rise in the Bank Rate and a restrictive monetary policy. The significance of this is that the Committee is recognizing the possibility of sudden inflows and outflows of money unrelated to any real changes in the nature of Britain's balance of payments on income account. They are, in fact, feeling their way towards a new technique of handling 'bad money'.

Two proposals are made which bear on this problem of increasing liquid assets. The first is that balances at the Bank of International

Settlements should be allowed to reckon 'for all purposes of the law as the equivalent of gold'. 'This provision', the Committee add, 'might be of the highest value in the future course of the evolution of international banking and would provide an important precedent in the development of methods of international banking practice for the economy of gold' (para. 346). The question of building up an international monetary centre is discussed elsewhere. The second proposal is that the resources of the Bank of England should be increased so that holdings of gold and/or valuta might amount to £225,000,000.

Events have moved since the publication of the Macmillan Report. Were Britain's gold stock to be revalued now, its nominal value would be increased by about a third. Further, the creation of the Exchange Equalization Fund has provided extra assets to be held against sudden fluctuations. This fund was first created on June 23, 1932, and its capital is at present some £375,000,000. In form it is a Government agency and not part of the Central Bank, but by providing quick assets in London, it appears in some respects to fulfil the recommendations of the Macmillan Report regarding the increase of the resources of the Bank of England.

The Macmillan Committee made a number of other proposals, some of which—such as the amalgamation of the Issue and Banking Departments of the Bank of England, and the form which any limitations of the Note Issue should take—seem rather remote in view of what has happened since the Committee reported. More to the point is the stress on the importance of close working between the Bank and the commercial banks (and also with the Treasury and the constituent elements of the Money Market). It is impossible to conceive of any successful monetary policy if close co-ordination is lacking. Yet the position is hardly as satisfactory as it might be.

'We have a central bank whose view, even allowing for its facilities for obtaining information, is inevitably narrowly circumscribed, except in international affairs, but whose control over the quantity of money, the principal instrument of monetary policy, is complete in all but the most exceptional circumstances. We have joint stock banks, with a more intimate knowledge of conditions throughout the country, possessing unco-ordinated powers to influence these conditions, but having no means of exercising those powers in an orderly way and no constant contact to that end with the central bank. For purposes of monetary policy there is a wall between "The Bank" and "the banks" far more difficult to scale or penetrate than any erected by the late Sir John Soane. Thirdly, we have a Treasury which, although it consults the central bank, has no contact with the commercial banks except as sources of revenue; which pursues

its course in jealously professed irresponsibility for monetary policy except when it involves legislation; and gives what appears to be scant thought to the effects on monetary affairs of any particular action in the field of public finance. We have only to ask a few very simple and pointed questions to see where this separatism and hazy division of responsibility lead us. For example: Who was in fact responsible—the Government or the Bank—for the return to gold in 1925? Who decided—the Government or the Bank—upon the present policy of providing abundant money supplies? Who at the same time restricted capital expenditure by local authorities—or was that merely an accident? On whose instruction or advice is the attempt made, by totally unconstitutional means, to check foreign investment by a ban on new issues of capital in the London market by non-British borrowers? If any one can answer these questions with some show of certainty he will know far more of the relationships between the Treasury and the Bank than any joint stock banker.'[1]

Mr. Crick concludes:

'If we are to overcome our liability to repeated economic catastrophes it is essential that we should take stock at short intervals of our principles, machinery and methods of monetary management. Only by the establishment of complete confidence and collaboration between the agencies directly concerned, supported by the fullest research into facts and the closest reasoning from them, can we ensure the removal of the monetary obstacles in the way of the upward movement in the level of real wealth. To this end we need a thorough overhaul of the relations, nowhere clearly defined, between the Treasury, the central bank and the commercial banks; and in this combination of powers the economist clearly has a place of scarcely less importance than those occupied by the banker and the civil servant.'

4. *Investment Machinery*

With the War has come a big change in the character of investors—partly the result of the logical development of the Joint Stock Company and partly the result of recent policies.

'The composition of the investing class in most countries has changed. With the elimination of big fortunes through inflation or other national disasters, with the application of progressive taxation in overtaxed states, with the decay of the great landlords, capital has become more evenly distributed and the small capitalist is necessarily less willing to assume risks than the great. He is, moreover, less able to control. Ownership of industry—through shares—is to the small investor divorced of all reality of ownership. He cannot influence policy; whatever his ideals may be, he cannot through his individual will determine the lives of the human beings

[1] W. F. Crick, 'Monetary Policy and Banking Practice', in the *Journal of the Institute of Bankers*, June 1933, pp. 345–7.

which that industry represents. He may gain or lose—he cannot control. Of the sense of immediate responsibility to which ownership should give rise he is deprived, and the desire to own which that sense engenders cannot be his. If he purchases equities, it is for profit alone—it is a form of gambling, less risky perhaps than horse-racing and less crude than cards. But it is a form of gambling for which the small is much less suitably equipped than the large capitalist. The individual stake is too high, and because it is too high the small investor cannot spread his risk. The large capitalist may devote one-tenth of his capital to purchasing common stock in a score of different companies, the profits on two or three of which may wipe out all losses. The small investor may have to place the whole of his tenth in one concern—and he is likely to be ignorant. How, indeed, can he choose between the rival recommendations of the financial tipsters in the daily press or interpret the obscurities of balance-sheets "taken as read"? As national income increases and more and more concerns are devoted to meeting that vacillating demand that now throbs and now relapses into quiescence, once the major needs are met, his difficulties increase and, failing to overcome them, his chances of the large compensatory profit diminish.'[1]

A series of Committees have considered different aspects of Britain's banking and industrial organization, the most important being the Cunliffe Committee, the Balfour Committee, the Colwyn Committee, and the Macmillan Committee. It is seldom possible to relate the recommendations of these Committees to particular reforms or innovations in Lombard Street or Whitehall. Nevertheless, the continuous study of the problems of finance and industry has produced such important developments as:

The Trades Facilities Loans.
The Export Credits Guarantee Dept. of the Board of Trade.
The Department of Overseas Trade.
The Central Electricity Board.
The Agricultural Mortgage Corporation.
The Bankers' Industrial Development Company.
The Lancashire Cotton Corporation.
Participation in capital of United Dominions Trust by Bank of England.
Participation in capital of Bank for International Settlements by Bank of England.
Creation of new Departments in the Bank of England.
Formation of Association of Investment Trusts.
Formation of British Insurance Institute.
The Companies Act of 1929.

The change in ideas that has occurred is at least as important as

[1] A. Loveday, 'Financial Organization and the Price Level', in *Economic Essays in Honour of Gustav Cassel*, London, Allen & Unwin, 1933, p. 412.

the creation of new institutions. The last ten years have seen important modifications in public opinion regarding the rights and responsibilities of the Central Bank, the duty of a Government towards exporters, and the responsibilities of Issuing Houses.

In their analysis of the situation the Macmillan Committee pointed to certain gaps in London's financial organization as far as industry was concerned. They gave it as their opinion that sales abroad of such things as machinery were less adequately financed from this country than from our competitors, and the same criticism applied to the financing of railways and harbours being built by British enterprise abroad. In operations such as these payment could not be made, for example, in three months' time, but would have to be spread over months and even years. Home industry also was handicapped in that, in the absence of industrial banking, there was no institution which could supply those needs which fell between ordinary banking facilities and those of the new issue market. There were many financial requirements which were beyond the power of the banks to supply; at the same time these might not be large enough to justify an issue on the Stock Exchange since the cost of making such an issue was proportionately much greater for small amounts than for large ones. In these circumstances the Committee looked for an institution or institutions which could play something of the part taken abroad by industrial banks. Such institutions would act as intermediaries between the existing investing public and smaller sound industrial concerns. They would give not merely financial support, but would also provide expert advice, and would 'take care' of the companies in which they were interested. If a somewhat fanciful analogy be permitted, they would act as 'building societies for industry'; that is to say, would bring together the investor and the industrialist somewhat in the way that building societies bring together the investor and the builder. Thus they would provide an opportunity for the investing public to spread risks, and in doing so would satisfy the needs of lender and borrower alike.

It is almost superfluous to stress the important part that such intermediaries could play. At the same time it is perhaps necessary to carry the discussion a little farther. With depression, the position as it was when the Macmillan Committee reported has in some respects been modified. Thus, for example, the large falling-off in foreign business has turned the City's thoughts nearer home, and as a result home industries—where concerns are sound and their prospects promising—probably receive much better attention than they did some years ago. Insurance companies with large sums of

money which they must invest are interested in any established businesses to whom they can lend money profitably. It may even be that the real advantage of the new intermediaries suggested would be in the experience they could acquire. The position of the established concern which wants to borrow is substantially better than it has been.

But this does not apply to new industry or to developing industries which have not proved themselves. If the needs of safe and established concerns are reasonably met, those of more speculative ventures (some of whom will turn out to be the established concerns of the future) have yet to be satisfied. Banks and insurance companies can only supply these needs in a very small degree since they are not institutions whose investment policy can be directed to supporting speculative industrial ventures. The type of intermediary which would be especially useful would be a risk-spreading one capable of pursuing an enterprising and advanced policy, making up losses in one direction with profits in another. The problem as it stands to-day must be formulated in some terms such as those.

If we examine the industrial history of the years before 1930 the urgency of the question asserts itself. Gramophones, the cinema, artificial silk, all show the same tendency; profitable beginnings—a boom in the industry concerned—excessive competition—general waste—liquidation—and, finally, the emergence of one or two large and strong concerns which have gained control of the industry and established themselves. With steadier backing, and less haphazard methods of financing, the purses of investors could be spared and the industry developed on sounder lines in the long run. With institutions to collect savings and use them methodically to develop growing industries much of the waste could be eliminated. With organizations to give adequate support and advice, hand-to-mouth methods of financing would be reduced and both consumers and investors would benefit. With the growing gap between the investor and the entrepreneur such institutions are inevitable, unless we are prepared to tolerate an inordinate amount of wastage. As things are at present the strong financial group only gets control once the damage is done.

In Great Britain a problem which has certain parallel characteristics is that of the so-called depressed industries. These industries will need two things: the reduction of excessive plant and a certain amount of modernization. Unfortunately unco-ordinated financing has prevented much being done beyond a limited amount of rather piecemeal rationalization. Some machinery is necessary which could

bring together divided financial interests, could secure the writing-off of bad debts, and could provide for new finance in the light of the needs of the particular industry as a whole. Here, again, if new capital is to be secured and employed in the most useful channels a joint policy in which all the banks are co-operating seems called for, and might be operated through an appropriate intermediary institution.

Lastly, there comes the important question of what might be called 'official' and 'semi-official' investment. This includes not merely capital expenditure by national and local authorities and by public corporations such as the Central Electricity Board, but also by bodies like railway companies in so far as they are dependent on facilities provided under the auspices of Government. All such expenditure is naturally under the supervision of the Government Departments concerned. These in their turn are, through the Treasury, in touch with the Bank of England. Thus the danger of issues clashing or of other inconveniences of this sort is avoided.

But it might well be asked whether such arrangements are enough. The ultimate problem is one of policy. Earlier on considerable attention was paid to the importance of concentrating public works in times of depression so that the financing of them should not compete with the needs of private borrowers during prosperity. At present all that happens is that steps are taken to make borrowers wait their turn. If official investment is to be concentrated during periods of slump a great deal of advance planning and of co-ordination will have to take place, and there is no organization directly concerned with distributing such activities to appropriate moments of time considered with reference to the sequence of boom and slump.

Proposals for reorganization on such lines have been made in the past, largely with reference to the setting up of a National Investment Board. In so far as official and semi-official investment is concerned, there seems little doubt that any attempt at the spacing of public works programmes will require machinery similar to that proposed by some sponsors of the plan for such a Board. The concentration of public works in particular periods of time will, if waste is to be avoided, require a great deal of co-ordination and forethought, and as things are at present there seems nobody in whose province such a task would naturally fall.

The general conclusion may be summed up something as follows: that special machinery is wanted, first, to finance new industries (and support the depressed industries) through methods of risk-spreading; and, second, to control and supervise official and semi-official investment in such a way that it is spaced out through time so as to avoid

clashing with the maximum demands of private investors. Such machinery would aid the monetary authorities in their task of controlling fluctuations of business activity.

Thus if of all nations Great Britain is best equipped for carrying through a coherent and enlightened monetary policy, she has still pressing problems to deal with. The debt burden is a heavy one; the relationship between the various parts of the financial machine is obscure, and so might prove a hindrance to unity of policy; and finally, there is room for improvement in regard to portions of the machinery of home investment.

SUMMARY OF PART TWO

We are faced with a specialized economic system supplying goods and services in constantly changing proportions. Various forces are all the time operating on this system, but very unevenly: alterations in the pace at which population is growing, innovations in technique, new discoveries of natural resources, changes of taste, changes in income distribution. The working of monetary systems can in itself produce disequilibrium, and even when it is not an initiating factor, a mistaken monetary policy may in itself exaggerate fluctuations due to other causes. For these reasons economic progress tends to be discontinuous.

Monetary policy should aim at providing a steadying influence by trying to prevent unwise investment and to even out as far as possible the demand for capital goods. This can be done if monetary authorities set out to preserve a continuity of values, thus avoiding the sweeping movements of prices (with their devastating effects) which have occurred in the past. Some members of the Group consider that the most satisfactory form of continuity of values could be in terms of stability of an index of wholesale prices; others would go farther afield and seek to stabilize prices in relation to costs. The latter consider that monetary authorities should conduct their policy in the light of a wide range of data—in particular in the light of the relationship of various groups of prices, including the prices of securities.

The powers possessed by monetary and banking authorities are several: Bank Rate, sales and purchases of securities in the open market, the changing of reserve ratios, the control of the direction in which bank loans are made, control over the policy of Issuing Houses, publicity. For monetary control to secure any high degree of effectiveness, two prerequisites are: first, much more complete statistics covering the whole field of economic activity; and second, the closest collaboration between the various elements in the financial system. Given these prerequisites monetary control should be able to prevent any wild swings under more or less normal conditions provided action is taken quickly enough.

Once the position has got out of hand, however, there is no easy remedy. Improvement may be hastened by an expansive Government policy reinforcing financial policy. The arguments are all in favour of a planned policy to concentrate any necessary public works in periods of depression, but they are more obscure as to the desira-

bility of relief works being undertaken purely as such. In theory it is desirable to aim at large budget surpluses in prosperity and to allow deficits during depression; but as regards any Government policy the probable reaction of public opinion must be taken into account. The Government should do all it can to stimulate private investment during depression, but in this respect its power is limited under conditions of private enterprise.

The main problems arising in the case of Great Britain since the War centre on the vastly increased debt burden, the challenged international financial supremacy, and certain defects in the machinery of investment. The increased weight of debt suggests the desirability of a high level of money prices, wages and salaries as against a low one, but from the point of view of aids to recovery it is important not to ignore the dangers surrounding any ill-judged attempts to bring about too hurried a rise. Financial problems are being dealt with fairly satisfactorily in a rough-and-ready manner—the Exchange Equalization Fund is especially important—but there may be a need for permanent machinery to secure a co-ordination and concentration of policies. The change in the character of the investor is one of the reasons which makes necessary improved machinery for the financing of new and untried enterprise in particular.

PART THREE

MONETARY POLICY IN THE INTERNATIONAL SPHERE

CHAPTER IX

THE SIGNIFICANCE OF AN INTERNATIONAL STANDARD

So far the field of monetary policy, and the economic activities with which it is faced, have been envisaged in terms of a single unit. This is arbitrary and an abstraction. The world as we know it is composed of a large number of independent countries each with a Central Bank —or some substitute for a Central Banking system—in charge of its financial administration. The powers of these Central Banks, the abilities of those who administer them, the difficulties which they may be called upon to surmount may be entirely different. Any generalizations about 'bank action' or 'monetary authorities' would appear to require a good deal of refinement before they can be applied to an existing state of affairs.

But it is not merely the existence, side by side, of independent monetary systems that adds to these problems. The difficulty goes deeper. National boundaries across which international trade is carried on are symbolic of political rather than of economic division, but the economic significance of national boundaries has grown greater rather than less in the last few years. Whether rightly or wrongly Governments exercise considerable control over the course of trade, and there is no sign of this tendency losing force. There are always vested interests anxious to bring pressure to bear upon the political authorities. The government itself is in one aspect a vested interest; it is interested in borrowing as cheaply as possible for its own purposes. Not only may the monetary authorities not be allowed to do what they think is best; but various political interests make for conflict. Any picture which seeks to describe the conditions of economic stability from one angle alone is very wide of the mark.

At the same time there is some warrant for such an approach. The world is a unit, the unit within which international trade takes place. Taking a long view, specialization is on a world basis, though it may be hindered and held up by the barriers which Governments are constantly putting in its path. If we are to get the most from the natural resources at our disposal, we must so arrange them that their benefits accrue to all countries taken in conjunction. The largest market is a world market, and certain industries—if they are to produce as efficiently as possible—are in need of the largest market they can have. The world is still very much of an economic entity.

Nevertheless, any attempt to relate the generalizations arising out

of the second part of this book to the world as a whole must take the world as we find it. International economic society, while from some standpoints unified, from others is cut up into small fragments by political boundaries and by the self-centred interests of sovereign states. These two aspects can remain in existence side by side in so far as there is an international machinery for making payments between country and country. The existence of world money-markets provides such a machine, and involves at least a broadly accepted set of rules governing financial transactions. These transactions are much facilitated under a properly working international standard. Hitherto the only form of this has been the gold standard, and, even if the gold standard is not restored, some set of conventions is likely to be evolved which will relate currencies to each other on defined principles.

1. *The International Standard and Continuity of Values*

When it is argued that a continuity of values is desirable if the ups and downs of business activity are to be reduced, the implication is that such a continuity of values is necessary in the world as a whole. This is a broad conception. We might envisage each separate unit trying to the best of its ability to keep things stable within its own domain. Again, we might picture some institution such as the Bank for International Settlements (developed greatly from its present status) acting as a sort of international Central Bank and trying to regulate the world economy. Either of these pictures would seem exaggerated. If we merely think in terms of small units we make no provision for changes as between unit and unit. If we think in terms of a world Central Bank we must not allow ourselves to forget that the power of that Bank will depend on the willingness of those in control in individual states to co-operate with each other for the common good. Both approaches have their importance.

From the narrower point of view the problem comes down to an alternative between a fixed external exchange and an internal continuity of values for any one country. But this is putting the dilemma in much too extreme a form. There may be more or less continuity with a fixed exchange, greater or less exchange fluctuations with a continuity of values. To put the two as absolute alternatives is not merely exaggeration; it is untrue.

No system of fixed exchange can possibly survive if values generally are allowed to drift in the world at large. The complete break-down of the post-War gold standard showed quite conclusively that a successful international standard ultimately depends on its ability to

provide reasonable economic conditions in the countries over which it operates. If general conditions are such that a reasonable stability is rendered impossible—whether through the working of the standard itself or from outside causes—the fixed parities will go, or will be maintained only through the polite fiction of restricted exchange dealings. The pressure of debts following on a complete collapse of values will break down any international standard. So far from being absolute alternatives, internal and external stability are largely complementary.

The converse serves to confirm the truth of this. If the aim be internal continuity of values the exchanges cannot be left to themselves. A country which took practically no part in the world trade might be able to do this without any ill effects; for a trading country exchange fluctuations can only mean both an upsetting of internal values and a reduction in world trade. The upsetting of internal values follows from the fact that the prices of imported goods are constantly changing just because an attempt is being made to keep the prices of all goods either steady or moving in a particular direction at a given rate. The reduction in trade follows from the fact that it will be impossible to make accurate estimates of what receipts will be. While it is possible to arrange for forward-exchange cover for any given transaction or for any given sum due on a fixed date, there is no basis for estimating future policy, and it is here that the difficulties of fluctuating exchanges make themselves felt most strongly.

Therefore it can be said that while from a very narrow standard internal stability and external stability are in conflict, from a broader point of view they are dependent on each other. Some exchange stability and some continuity of values there must be throughout the world as a whole; the question is where the emphasis must be laid, and that in its turn must depend on the practical possibilities of securing an effective international system and on the machinery available.

2. *International Lending*

An international standard such as the gold standard makes easier the process of lending abroad. If goods were paid for as they were bought, the problem of exchange fluctuations would be much less important, but this is seldom the case. Even with normal consumers' goods, payments wait for a period of three months or more. With capital goods the period is a much greater one; British investors may in fact be lending a railway to the Argentine and securing payment out of the wheat this railway carries from areas which it has made accessible. Payments are not momentary: they take place at intervals

of time, and if people are to be willing to enter into agreements which involve payments in terms of a foreign currency at fixed intervals they will wish to feel fairly certain not only that these payments will be made, but also that they will be satisfactorily converted into their own currency.

Therefore fluctuating exchanges tend to reduce the volume of lending, and increase the risk premium demanded by lenders. The damming up of the normal international flows of capital means that savings have to seek investment within national boundaries, which in its turn means an excess of savings and low rates of remuneration within the country, and a shortage and high rates elsewhere. Further, there is a dislocation within the lending country if its industries which have specialized in making capital goods for export find themselves without orders because the money loans out of which their orders are paid for have ceased.

Under more normal conditions—for example, under conditions such as existed in the pre-War period—a reasonably free flow of capital helped to even out the returns on it in different countries; investors sought out the most profitable opportunities and exploited them. Great Britain was the chief lender.

'For many decades back the natural resources and industrial operations of the British Isles had not offered as great opportunities for gain—differences of risk and circumstances considered—as had those of foreign lands. Unobstructed by law, invited especially by lands to which the British people were spreading, solicited and directed by able young Englishmen, who in large numbers sought their fortunes in developing the resources of young countries, much of these savings found employment abroad. They took the whole of the outside world as the field of opportunity—and in so doing propelled that outside world into the stream of history along which Europe moved.'[1]

This investment was based in the main on economic considerations, especially in the case of Great Britain. The flow of British capital into the outer world

'was no regular and uninterrupted trend. Resting, as it did, upon individual calculation, it rose and fell, was active or inactive, according to the multitude of conditions which determined the investors' judgement. The movement of interest rates, the state of business at home and abroad, the financial condition of borrowing governments, the shock of losses experienced, the lure of newly discovered opportunities abroad, wars and rumours of war—these are but a few of the matters which decided the volume of investment abroad at any one time.'[2]

[1] Feis, *Europe; the World's Banker*, Yale University Press, 1930, p. 4.
[2] Ibid., p. 11.

In the post-War period the flow of lending was resumed, but it was dominated much less by economic considerations. The reasons for this were twofold. In the first place, the basis for calculation was much less precise. Much had been destroyed in the War; the needs of borrowers were large; the risks were difficult to estimate; there was a greater tendency for Governments to borrow at a time when there were few private interests strong enough to borrow on their own initiative. Loans became loans to countries rather than loans with specific objects in view, and in the general trend and excitement relative risks and real remuneration were difficult to estimate. The orgy of lending and borrowing which we now condemn was possible because the opportunity of judging the future was more remote. In particular, the American investor was inexperienced and unable to assess exactly what he was doing. When we remember how fantastic were some of the estimates of reparation possibilities made by authorities of repute, we can see how all the basis of calculation had been swept away and how the blame for the 'bad lending' in the post-War period can only partially be assigned to the agencies which promoted this lending.

The second reason for the pushing of economic judgements into the background was the growth of political motives behind international lending. Lending had not been unaffected by political influences before 1913,[1] but these influences became much stronger in the post-War period. Allies had to be supported, new powers had to be encouraged, political disorder had to be averted, reparations had to be paid; however worthy the motives behind these loans, few of them bear any relation to the extension of productive capacity, and for many of them the possibilities of repayment were obscure. While it is important not to overstress the extent of 'bad lending', since subsequent depression made unpayable many debts which might reasonably have been paid under more prosperous circumstances, it is significant that economic motives have had much less free play in the post-War period. To a much greater degree Governments had a vested interest in the lending and borrowing process.

In due course with the depression circumstances led to a slowing down, and almost a complete cessation, of the lending process. The future of lending is obscure, but there is no doubt that, though the opportunities for profitable investment overseas may be reduced, they are not completely at an end. The volume of lending may fall off, but international lending will still be of importance.[2] If this is admitted, the argument in favour of an international monetary system

[1] Ibid., Part II, *passim*.

[2] See below, pp. 159–69.

worked on systematic lines is reinforced. In so far as lenders know what they will receive and borrowers what they will pay, the opportunities of lending are increased.

But there is a further necessity which an international monetary system alone would appear to satisfy completely. Lending abroad must be related to the surplus available on balance of payments if chaos is not to result. The gold standard as worked before the War did roughly preserve this relation: if too much was being lent abroad from London gold flowed out, rates were raised, and it became less profitable for anybody to borrow from London, but more attractive to lend to London. The method may be crude, but within its limits it was effective. It must be noted, however, that it depends on a hypothesis of 'normality' which has not been realized in the post-War years: the hypothesis that gold movements depend on economic rather than 'psychological' motives. But the important thing is that under any effective system technical provision must be made for the relating of foreign lending to a country's balance on international account.

3. *The International Specialization of Productive Resources*

An element of stability is important for a further reason: without it it is impossible to estimate the relative profitability of different enterprises in different parts of the world. The significance of an international standard lies in the fact that it provides a basis for judging the comparative advantage of producing particular kinds of goods in particular places. It is the object of international trade to enable countries to specialize just as individuals or localities specialize, and so to provide for the world as a whole the advantages of production under most efficient conditions. Different countries have certain advantages in providing this or that type of article. The concentration of production in the most advantageous places, and production for as large a market as possible, has been the condition under which efficiency has increased and which has enabled the world to supply itself with a greater and more varied supply of goods.

This tendency has worked automatically under the influence of free competition, but it presupposes what might be described as a reasonable opportunity of calculating costs and profits. The development of a new enterprise in a particular part of the world, or even the laying down of a policy for an existing enterprise, involves the manager of a concern in the attempt to gauge what he will have to pay out in expenses, what sort of output he can profitably maintain, what prices he can look forward to with reasonable confidence. His

calculations will be upset by change: thus the raising of a tariff will be a factor which he probably cannot judge but for which he must, if his expectation is not to be falsified, make allowance. On the other hand, the unchanged existence of a tariff is not a disturbing factor in the same sense; it is true it may prove decisive in preventing him from adopting a certain line of policy, but it is a known quantity. But disturbing changes—the knowledge that tariffs are likely to be constantly chopping and changing—merely slow down all enterprise and make men wait for a time till they can see the position more clearly. New developments must wait till the storm is over.

Of all disturbing changes, widely fluctuating currencies are perhaps the worst because they affect not merely payments (ingenuity can largely get round that, and theoretically if the worst comes to the worst one can always descend to barter) but prospects, for no amount of ingenuity will make clear which prospects are reasonably assured, at a time when constant changes are going on. If currencies were stable in terms of each other, or if—to take another alternative—they varied exactly in proportion to real changes going on within countries, the position would be a known one. When this does not happen a slowing down of trade is the inevitable result.

Without some common basis the effective international specialization of productive resources becomes impossible. Stress has been laid above on the important part that the flows of international lending play. This lending can only take place as long as the possible profits and risks involved can be assessed. If unexpected exchange fluctuations may double profits or turn them into losses, making risks quite unassessable, the lending flows will slow down. This will mean a general slowing down of new development, and will tend to have a deflationary effect.

4. *International Standards and Localized Indebtedness*

It might seem at first sight that from the economic standpoint national boundaries were of no more significance than boundaries between any other administrative divisions. Industries would pass from one country to another as conditions changed. Production would follow demand. A payment from one country would automatically mean less money there and more in another. As long as there was no interference, adjustments would take place quite spontaneously, as they do within countries.[1]

[1] Though even within countries—if they are large—difficulties arise. Thus the history of banking in the United States is dominated by the fact that one part of the country is afraid that credit facilities will be denied it which are being accorded to other parts.

Such a picture is partly true, and does hold certain important aspects of the truth. It ignores, however, important factors such, for example, as the relative immobility of labour. Within national boundaries labour is free to move from district to district in search of the most remunerative employment; between countries this is not the case to anything approaching the same extent. Even before recent immigration restrictions had done much to keep people in search of work in their own national boundaries, opportunities were limited by language and custom. Given these facts, it is impossible to say that from the economic standpoint nations are no more than administrative divisions.

Then there is the question of Government debt to be brought into account. Prosperity may pass from one country to another, but Government debts remain firmly rooted to the taxable capacity of people living within fixed national boundaries.

'This may best be illustrated by analogy. Let us suppose that after the War the total debt of Great Britain was distributed on the rates in right and proper proportion. Tyneside, the Clyde, and South Wales, all of them in a reasonably prosperous condition, are duly assessed. All is well for the moment—the increase in the rates is offset by reductions in national taxation. But in due course the centre of prosperity shifts, and the indebtedness cannot shift with it. How are the ratepayers in South Wales to pay their share when the coal trade is failing? In fact what happens is that the burden of indebtedness within a country is mobile; the failing industries pay less as their profits decline, and the new industries—at Dagenham or Slough, or wherever they may be—pay more and more as their prosperity increases. The burden shifts automatically.

'This happens within a country, but debts are not mobile as between countries. Certain theorists maintain that as long as this is the case it is idle to pretend, as has sometimes been said, that payments between countries can be satisfactorily dealt with as if they were on the same footing as "payments between counties". They argue that any international monetary system that is to be of value must have within it the capacity for change and readjustments, and cannot throw the whole brunt of change on national economic structures alone.'[1]

Thus it will be seen that there is a necessity, on the one hand, for a common world monetary basis, an international standard in its widest sense, using that to cover a rigid gold standard at one extreme and a more or less general understanding as to how exchange equalization funds are to be worked at the other. This 'standard', on the other hand, will have to deal with a whole set of technical difficulties arising out of the facts that the distribution of indebtedness is uneven,

[1] *Monetary Policy and the Depression*, p. 74.

and that the world is constantly changing. Mankind produces different goods and demands different goods from year to year, and populations increase or decrease at different rates. At intervals the world economy may be upset by upheavals such as war. What these problems are, how they may be dealt with, and the international arrangements which appear to be the most attainable and most suitable, is the theme of the following pages.

CHAPTER X

THE GOLD STANDARD AS A WORKING INSTITUTION

IN the past an international monetary standard has meant the gold standard. The theory underlying the gold standard was that it imposed, upon a world of separate national states and national currencies, the same conditions as would obtain if the currency itself were international. In fact, to be on the gold standard meant that, although the various national currencies were not exclusively composed of the precious metals, yet they were managed as if they were. Thus international payments had the same significance as payments within the national area, so far as fluctuations in the local money supply were concerned. A payment from Edinburgh to London and a payment from London to Montreal meant in each case a tendency towards a diminution of balances in the paying area and an increase in the receiving area. Arbitrary increases in the local supply of money could take place only under the menace of the breakdown of the gold standard.

This served a definite purpose. It did not safeguard the economic system against disturbances due to variation of the total gold supply, or expansion or contraction taking place more or less simultaneously throughout the banking system as a whole. But it did bring about adjustments of inter-local disequilibria, and thus did away with at least one cause of economic disorder. Nor was it fool-proof; the preservation of the system clearly depended upon the policies of Central Banks reflecting such variations as would have occurred under an automatic system of purely metallic currencies with no other types of money.

The War had a profound effect upon this international monetary system. The pre-War and post-War gold standards had certain technical differences—discussed below—but overshadowing all these is one vital distinction of general economic significance: the pre-War gold standard was the result of an increasing international relationship between prices and costs; the post-War standard was set up in the hope that it might restore such a relationship. The former was organic, the latter synthetic. The one was the result of *de facto* specialization of productive resources; the other was intended to restore and foster the further development of internationally advantageous specialization with which war-time and post-war influences had seriously interfered.

1. *The Pre-War Gold Standard*

One of the characteristics of the gold standard in the pre-War period—and this separates it most clearly from the post-War system—was the circulation of gold coins as currency in most of the leading countries. The ability to transfer gold abroad and to take gold to or draw gold from a Central Bank gave a common basis to all currencies. As soon as the exchange moved beyond very narrow limits it paid to export gold in payment of debts. The gold points, the bounds within which it paid not to move gold having regard to the difference between the banks' buying and selling price, the cost of shipment and other costs, were then—as in 1925–31—quite close together.

These narrow limits made the exchanges a very sensitive indicator for bank policy. A slight movement either way, and gold would either come in or go out. If there was a loss of gold the Central Bank would raise its discount rate, and this would affect the payments being made through the exchanges because higher interest rates in the short run would make it more profitable to keep money at home instead of lending abroad (and might also attract money from abroad), and in the long run would bring pressure to bear upon industry at home to reduce its costs. Thus the movement of gold was the foundation which kept the different national currencies linked to one another.

But this, though correcting the position as between different countries, did not provide a control over any general movements of activity which might be happening over all countries simultaneously. During the pre-War years there was something of a control of this sort owing to the predominant position of London in international finance. Not only did Great Britain have such a dominating position in the short-term money market that she was able to control the cost of financing goods while they were being moved from producer to purchaser, but as the largest supplier of capital on long term she influenced lending the whole world over. It may even be that economic and commercial activity abroad was more sensitive to a change in the London Bank Rate than was such activity at home, for at home bank charges have, on the whole, tended to be rigid.

The pre-War system was working in a reasonably free international environment.

'The credit system of the world', records Professor J. H. Jones,[1] 'was not only firmly organized, but organized in such a way as to facilitate the working of the gold standard. The Bank of England acted not only as the Central Bank of Great Britain, but also as a sort of International Bank of

[1] Professor J. H. Jones, 'The Gold Standard', *Economic Journal*, 1933, pp. 564–5.

Economic Settlements. In time of need it was able to draw funds from other countries and to employ those funds at the place of need and in the manner dictated by that need. One of the outstanding features of the system was that, when any country was in distress, the Bank of England was able and ready to mobilize the reserves of the world and to rush to the rescue of that country. Credit or liquid capital was thus a balancing influence rather than an influence employed to destroy an existing state of equilibrium. If actual gold was needed it was forthcoming, as in the case of the United States of America during the crisis of 1907; if a short-term loan was needed, gold was not unnecessarily moved from one country to another; gold movements merely supplemented credit operations. Gold was not an alternative to a short loan, neither was it moved about in such a way as to necessitate a counteracting short-loan operation. Both credit and gold movements were correcting rather than disturbing influences; they restored rather than destroyed equilibrium. The Bank of England adopted a more or less neutral attitude in the sense that it performed the essential functions of an International Bank and regarded the problem of monetary stability as an international problem. I do not, of course, suggest that its attitude was altruistic and that Great Britain voluntarily adopted such an attitude merely in the interests of world stability and progress. Such was not the case. The economic structure of Great Britain and the position that she held as the largest investing country and the centre of world finance made her individual interests identical with the interests of the world as a whole. There was no conflict, or presumed conflict, between the one and the many.'

Professor Jones stresses four other characteristics of the pre-War gold standard. First, the national monetary systems were interlocked on a basis which fairly reflected relative internal prices and costs (in contrast to the post-War arbitrary valuation of the pound, the franc, and other currencies). Second, savings were regularly invested in long-term securities often of an equity character (in contrast to the post-War demands for Government bonds and for short-term holdings which could easily be shifted from centre to centre). Third, investment policy and industrial structure were more or less complementary to each other in the leading countries. 'Thus, for example, the industrial structure of Great Britain and the annual overseas investments of Great Britain formed pieces which fitted together to form part of the economic mosaic.' Fourth, tariffs and such restrictions were fairly stable and were not employed 'to correct temporary failures to balance international payments during periods of depression'.

Thus the working of the gold standard in the pre-War years was made easier because the environment was less disturbed and the position of London acted as a steadying and unifying influence. On the

other hand, there was no mechanism for smoothing out fluctuations, whether due to changes in monetary policy which sterilized or released supplies of gold as a credit foundation, or to any other causes. Large oscillations in trade and production did in fact occur, though they may seem unimpressive compared to the more hectic experiences of the post-War years.

2. *The Post-War Gold Standard*

The post-War gold standard had changed both in respect to the conditions under which it was working and of the form which it took. Four aspects of this change may be considered.

First, gold coins had disappeared from use. Any individual was free to demand gold from the Bank of England, but he had to take it in the form of gold bars and the minimum quantity which he had to apply for was large. This arrangement helped to some extent to cut out the amateur gold-hoarder and others who might demand gold for no financial purpose. This is the gold bullion standard, in contrast to the pure gold standard of the pre-War years. The change has significant effects.

'In the first place, the traditional maintenance of a minimum percentage, or other specific relation, between monetary gold reserves and the quantity of currency in circulation had become meaningless, except as an indicator of the extent to which internal inflation or deflation was likely to affect the exchanges through the medium of the price level. In the second place, in proportion as the relation between reserves and internal liabilities diminished in importance, that between reserves and external liabilities at short term became more and more vital. Government and other fixed interest-bearing international debts had vastly increased, and the international pool of short-term funds was also much greater and more mobile than before the War, largely owing to the development of the New York market and the extension of the Gold Exchange Standard. Had steps been taken to ascertain the totals of external short-term liabilities—not merely of the Central Banks or Governments but of the countries as a whole—a comparison between those figures and gold stocks would have given a picture of the strength or weakness of the various note-issuing authorities very different from that given by their published reserve ratios, and very much more illuminating.'[1]

The term Gold Exchange Standard needs explanation. Owing to the limited supply of gold, and for other reasons, many countries were unable or unwilling to hold their reserves in the form of bullion.

[1] H. V. Hodson in *Survey of International Affairs 1931*, Oxford University Press, issued under the auspices of the Royal Institute of International Affairs, p. 163.

'A country adopting the Gold Exchange Standard holds, as part of its legal reserves against the note issue, obligations payable at sight in terms of foreign currencies which are themselves legally exchangeable into gold. . . . Among the countries that adopted this indirect method of backing their currencies with gold were Austria, Czechoslovakia, Italy, Rumania, Finland, Estonia, and Jugoslavia.'[1] The Gold Exchange Standard was a useful device, but it had at least one important drawback. Since two currencies were built, as it were, on the common foundation of one single amount of gold, it meant that any weakening of that foundation through loss of gold might affect both currencies in the case of panic and liquidation. The Gold Exchange Standard was hardly fitted to survive stormy weather.

The second aspect of change is concerned with the loss of London's dominant financial position since the War. Great Britain is no longer the great financial power. She has had to share her leadership first with New York, and later on with Paris as well. The result of this is that the unity of policy which marked the working of the gold standard in the pre-War years is lost; New York is an inexperienced lender and Paris an unwilling one, and the pull between the three great financial powers has proved a disturbing influence.

Third, the post-War gold standard had an unhappy beginning which was largely to prove responsible for its unhappy end. It is now accepted that Great Britain went back to the gold standard at too high a parity and France at too low a one. These disequilibria were bound to be a disturbing influence until they worked themselves out, and this initial handicap proved too great. A further source of disequilibrium lay in the fact that the distribution of gold and obligations was such as to make the world's *effective* monetary gold stock an unstable quantity.

Fourth, as might be expected, the period was one of great political and economic instability in which the risk factor was playing a very big part. Industrial development had been warped during the War, and the big economic changes which were called for did not prove welcome politically. Hence the uncertainty of trading conditions, and the constant changes in tariffs which in pre-War years had proved fairly stable. Further, the problem of providing for War Debts and Reparations added to the uncertainty.

Quite apart from all these considerations, the problem of the gold supply still remained in the background. If money is ultimately based on gold, an increase in the supply of money must ultimately be based on the supply of newly mined gold. There is no inevitable

[1] *Survey of International Affairs 1931*, p. 165.

reason why this supply of new gold should bear any fixed proportion to the world's need of new money as production increases. Therefore the world is tied to the fortuitous discoveries of mining engineers, or else it must make adjustments within existing credit structures which economize in the use of gold if there is a deficiency, and which sterilize an excess of it.

3. *The Proposals of the Gold Delegation of the League of Nations*

Many of the subjects discussed above were surveyed by the Gold Delegation of the Financial Committee of the League of Nations, which presented its final Report[1] in June 1932. The terms of reference of the Delegation, which was appointed in the summer of 1929, were to 'examine into and report upon the causes of fluctuations in the purchasing power of gold and their effect upon the economic life of the nations'. In the light of subsequent happenings these terms inevitably look somewhat restricted and academic, but the Delegation interpreted its task widely and its conclusions are important.

After examining the causes, and the sequence of events, that led to the break-down of the gold standard, 'the Delegation considers the return, within the shortest possible time, to the International Gold Standard system of such vital importance for economic and financial development that it feels its obligation to consider the policy that should, in its view, be followed in order to facilitate the achievement of that aim' (para. 80). It lays down three conditions necessary for such a restoration:

(1) 'the restoration of a reasonable degree of freedom in the movement of goods and services';
(2) 'A satisfactory solution for the problem of reparation payments and war debts'; and
(3) Central Banks should adopt 'certain guiding principles in respect of the working of the gold standard system', the most important of these principles being 'that, as a general rule, gold movements should not be prevented from making their influence felt both in the country losing gold and in the country receiving gold.' (Para. 81.)

The Gold Delegation adds a further condition in respect of individual states; that budgets should be balanced 'on sound principles' and that national economic systems should be balanced and healthy.

These are the general recommendations of the Delegation, which is more specifically concerned with gold and prices. The conclusion on the subject of the price-level is a cautious one.

[1] League of Nations: *Report of the Gold Delegation of the Financial Committee*, Geneva, 1932.

'The stability of the price-level which we envisage as being practically possible is a relative, but not an absolute, stability of wholesale commodity prices as measured by their movement over a long series of years. We do not conceive it as possible to eliminate short-term fluctuations of the price-level, but we believe that these shorter-term fluctuations would be appreciably reduced in severity if the longer-term trend were relatively stable. Nor do we conceive the possible measure of stability as inconsistent with slow movements of the long-term trend either upward or downward. What it is desirable to avoid, as far as possible, are such violent price-fluctuations as the world has recently witnessed. Such a measure of stability, however, can, in our judgement, be achieved only by the development of a flexible monetary and general economic policy which would allow the play of economic forces to bring about minor short-term fluctuations in individual prices and the average level of prices.' (Para. 186.)

The indicators of monetary policy, the Delegation held, should be several and should be 'interpreted by the judgement of central bankers and expressed in national policies arrived at after due consideration and co-operative consultation concerning their international repercussions. Movements of the index-numbers of wholesale prices should be used, not as a single determinant criterion of immediate policy, but as one among many factors to be taken into consideration' (para. 187). Other indexes suggested were: the market rates of discount, the yield of bonds, the prices of different classes of shares, the value of building permits, the debits to individual accounts, the production of various primary products, the international movements of capital.

Thhse are the international criteria. 'In considering monetary policy from the national point of view, the primary index should, in our opinion, be the historic index of the gold reserve. We consider that in recent years too little attention has been paid by monetary authorities to changes in their reserves—to the net imports and exports of gold. There has been, on the one hand, an endeavour to offset gold movements, on the other a belief that, whatever the circumstances, gold movements will produce automatically the necessary effects' (para. 195). It is suggested that, so far from gold movements being offset, their effects on the credit structure of a country should be reinforced by the action of the Central Banks. On the other hand, there are certain special conditions under which offsetting may be advisable. 'Temporary disequilibria may arise through causes over which the country mainly affected has itself no direct control, such, for instance, as a failure of crops or financial difficulties in one of its main export markets. They can be met by temporary gold movements or by the provision of short-term credits' (para. 202).

But if Central Banks are to control the position properly they must have full information at their disposal. With this information they will be able to discharge their duties more exactly, especially as regards watch over the balance of payments.

'While borrowing countries must thus watch and control the volume of their borrowings and assure that the funds obtained are devoted to productive purposes, it is necessary for lending countries to assure that foreign lending does not exceed or fall short of their net active balance on income account. For this purpose, in normal circumstances, the use of the discount rate, reinforced if need be by open-market operations, should prove adequate. But the willingness of the public to invest abroad may be affected by events wholly outside the control of monetary authorities, such, for instance, as the threat of political trouble. In certain countries, also, the machinery for foreign lending is insufficiently developed. Lending must not be impeded by artificial restrictions, such as discriminatory rates of taxation. We believe that any measures designed to improve the mechanism for the issue of foreign loans or to promote international transactions in existing securities, would contribute to the smooth working of the gold standard, granted the powers of Central Banks to control temporary disequilibria are adequate. We have in mind such measures as the improvement of facilities of foreign investments, the quotation of foreign securities on national Stock Exchanges, the equalization of taxes on domestic and foreign investments. We also attach particular importance to the discussions now taking place with a view to the solution of the problem of double taxation. The high rates of taxation in certain countries constitute an insuperable barrier to capital movements in cases when, owing to the absence of any international understandings, the owner of foreign securities is liable to be taxed twice on his holdings. We realize, however, that all these various measures designed to facilitate long-term lending and the international purchase and sale of securities will require time for their perfection.' (Para. 205.)

The Report next turns to the problem of economizing in the use of gold. It suggests that gold reserve ratios should be reduced from their present high levels. 'If this were done, the immediate effect would be to free the hands of the Central Banks by enlarging the free margin of their gold reserves which they can use for international payments without endangering the legal minimum ratio' (para. 212). Unlike the Macmillan Report, the Report does not consider it either practical or advisable to abolish legal minimum reserve ratios altogether. They consider that legal minimum ratios sustain public confidence, simplify the task of Central Bankers, and reduce the possibility of political pressure being brought to bear upon them. The reduction of ratios should increase the supply of gold sufficiently without making necessary complete abolition; such a reduction

should take place by agreement more or less simultaneously in the principal countries concerned. Some further minor suggestions for economizing gold are also given, among them being the increased use of cheques.

The report admits some of the criticisms urged against the Gold Exchange Standard.

'But it still offers the cheapest, and in some cases almost the only, method by which countries which are unable themselves to afford the heavy expense of a gold-standard system, may yet participate in the advantages of stable exchanges which such a system will again offer, if and when it is restored. It is inevitable that those countries which choose, or are forced by circumstances, to retain, or readopt a gold-exchange standard for the regulation of their currency will endeavour so to organize it as to minimize the possibility of once again being faced with heavy losses.

'Two possibilities have been suggested. The first is that such countries will choose carefully among the principal financial centres those which offer the greatest promise of future stability. The other is that an endeavour should be made to spread the risks of losses by utilizing such an international institution as the Bank for International Settlements as the agency through which the system shall be administered. In the latter case, the reserve assets of the gold-exchange standard country would be deposited with the International Bank which would in turn spread its deposits among its constituent Central Banks.' (Para. 221.)

The Report concludes by stressing once again the importance of freer trade, greater flexibility, debt settlements, and international economic co-operation.

4. *A Criticism of these Proposals*

It is perhaps unfair to criticize proposals which have been summarized briefly without reference to the arguments on which they are based. Further, it is important to remember that the terms of reference under which the Gold Delegation was working were narrow in their scope. At the same time, some attempt to evaluate the significance of the proposals which have been put forward is inevitable.

An examination of the Report suggests that the main line of criticism must be a double one; the report is ambiguous in essentials, and on closer examination its suggestions turn out to be in the main nothing more than aspirations—statements of needs instead of constructive proposals.

The ambiguity is present in the initial suggestions. On the one hand, the Delegation is urging a revival of the gold standard 'within the shortest possible time'; on the other, it is laying down as the necessary condition of such revival a reasonable freedom of trade,

a debt settlement, and measures of this sort. It fails completely to face up to the question of priority.

The very interesting examination of the problem of price stability is an example of a statement of a need. After laying down certain significant generalizations the discussion is left in the air. The machinery of co-operation and the specific forms that it might take are left unconsidered. The same tendency to neglect the following up of implications is shown in the discussion of the Gold Exchange Standard. The two facts that emerge are: that to some extent the Gold Exchange Standard is inevitable, and that it gives rise to special problems and difficulties. Methods of dealing with the latter are merely mentioned in two or three sentences. One suggestion is that countries will choose carefully among financial centres that offer the greatest promise of stability. The alternative to this somewhat obvious advice is that an international institution such as the Bank of International Settlements might be utilized. But the Report neglects completely to explore this interesting possibility.

The one concrete suggestion which emerges from a reading of this Report is that the Gold Reserve ratio should be modified downwards. But there is little attempt to explore the practical position. The suggestion for modifying gold ratios is an admission of the principle of currency management in one of its aspects—but there is no attempt to define how the principle should work. While we are told how the use of gold can be economized, we are not told at what rate[1] or in what circumstances economies of this sort should be made.

Thus the report of the Gold Delegation, while it does a good deal to clarify the issues and to draw attention to problems involved, does little to bring us any nearer to the understanding of practical methods for the solution of these problems. In any case, the period which has elapsed since the Delegation reported has seen many significant changes and has produced new problems.

[1] But at the London Conference a resolution was passed on this subject. See below, p. 200.

CHAPTER XI

MONETARY PARITIES

DISCUSSION of the international monetary problem centres very largely on questions of parities, of their fixing, and of their variation. Consequently the significance of exchange rates, and their relationship with real or hypothetical parities, deserve examination in some detail. By parity is meant the definite rate at which one currency normally exchanges or should exchange into another. Under a gold-standard system parities are fixed; the question arises, What are the determining factors which make this or that level appropriate? Further, the question of varying parities arises: To what extent, and under what circumstances, should they be changed, if at all? Lastly, it is important to consider the principles on which machinery for controlling exchange quotations—such as the Exchange Equalization Fund in Great Britain—should be worked.

1. '*Purchasing-power Parity*'

It is now admitted that Great Britain went back on to the gold standard at too high a parity in 1925, and France at too low a parity in 1928. This means that the structure of prices and costs in Britain was too high taken in relation to the structure in other countries. The result was that, owing to high costs, Britain found herself unable to keep her position in world trade, and the unemployment which marked the post-War years continued even at a time when other countries were enjoying fairly prosperous conditions. With France, on the other hand, the opposite was the case. So strong did her position in world trade become that, taken in conjunction with reparations, she had such an influx of gold that the Bank of France had to profess itself unable to control the position. Disturbing factors such as these made an international standard unworkable.

Building up from the rather negative conception involved in these experiences, we may define purchasing-power parity as being the rate of exchange between one currency and other currencies at which the balance of payments will be in equilibrium, the normal exchange of goods and services being facilitated, and capital movements being kept at a reasonable level and properly invested; there will be no piling up of balances so big that unnecessary supplies of gold are sucked in, and on the other hand the balance of payments will not be so unfavourable as to cause unwarranted borrowing unrelated to the profit-earning assets created thereby.

In a world in which currencies are constantly fluctuating in terms of each other, this real parity may be considered as the rate at which, once stabilization took place, equilibrium would be reached with the minimum of change. Change—whether it be inflationary or deflationary—must prove a disturbing factor. Where there is no stabilization the exchange rates may be swung violently in one direction or another at any moment by payments being made at the time, and these payments may and probably will be swollen by movements of short-term funds anxious to avoid loss. It can be said that at that moment, were stabilization to take place, that level would be preferable which reduced to a minimum consequent internal contraction or expansion in the countries concerned.

It is not easy to see where this point may come. One cannot, for example, compare the prices of goods entering freely into international trade in two countries at any moment and arrive at any relevant conclusions. The more freely goods enter into international trade, the more accurately they will reflect, not true parity, but the exchange rates of the moment. It is quite impossible to base any satisfactory deduction on the prices of goods for which there is an active world market.

The clue to the difficulty is to be found rather in internal prices and costs. Professor Cassel, who has done much to throw light on this particular set of difficult problems, asks the question, 'What is the principal reason for a foreign currency being in demand, and what effect has an alteration in the intrinsic value of that currency upon the demand for the same?'[1] This question leads him to the following line of argument: 'Our willingness to pay a certain price for foreign money must ultimately and essentially be due to the fact that this money possesses a purchasing power as against commodities and services in that foreign country. On the other hand, when we offer so and so much of our own money, we are actually offering a purchasing power as against commodities and services in our own country. Our valuation of a foreign currency in terms of our own, therefore, mainly depends on the relative purchasing power of the two currencies in their respective countries.'

The emphasis here is definitely on internal purchasing power. This in its turn will depend on prices and costs, so we must look to the price structure in each of the two countries and see how they compare. As soon as we do this we come up against further difficulties. The two countries will have differing natural advantages and differing efficiencies, and the commodities which they produce will hardly be

[1] Gustav Cassel, *Money and Foreign Exchanges after 1914*, pp. 138–9.

the same. There is a dilemma. Either one can try and consider the prices of goods with a free world market, in which case the comparison becomes meaningless, or one is forced to compare goods of different types, which again seems a profitless business.

Cassel resolved the dilemma in an ingenious manner. If, he argued, one can say with reasonable confidence that such and such a parity was a true one at some point in the past, one can then calculate the divergence of indexes of prices and wages since that date in the two countries chosen. By comparing these divergencies one can find out approximately what the true rate should be at a given moment.[1]

This argument must be qualified in several respects. The fact is that all calculations of this nature depend on an assumption of other things remaining equal which in actual practice is never realized. They assume that the terms of trade are unchanged,[2] and that the willingness of one country to take another country's exports in exchange for its own remains the same. This assumption is unjustified, and the only question which arises is whether in a period of this sort the change is big enough to affect the results substantially. Probably changes will not be very sweeping, but they will be important enough to make the result only a rough calculation.

Further, tariff changes also affect the results. To some extent such increases may, and probably will, cancel out, but they make the calculation even more approximate.

But the significant fact—as we learnt after 1925—is not what is happening at the moment, but what is likely to happen. If recovery is more advanced in one country than another, it is difficult to argue that any point chosen in the light of the situation at that moment is likely to prove an equilibrium point. If we are to find an equilibrium point, we must assume a more or less parallel state of affairs in the two countries. Professor Cassel's hypothesis of a 'point of balance towards which, in spite of all temporary fluctuations, the exchange rates will always tend' (this is his definition of purchasing-power parity) is clearly a stationary one. At any given moment there is

[1] For experimental calculations on these lines see *The Economist*, 18 and 25 Nov. 1933, and Mr. N. F. Hall's Supplement to *The Economist* of June 1934, in which the sterling exchange is examined in some detail.

[2] This is the crux of the matter. British importers do not demand purchasing power in America for the purchase of 'goods' generally, but in order to buy particular types of goods—and this changes the American price structure. See Ohlin, *Interregional and International Trade*, *passim*. Also Wilhelm Keilhau: 'The Valuation Theory of Exchange', *Economic Journal*, June 1925. The latter points out that currency is in demand not only to purchase goods but also to pay debts and make investments. Changes in these respects will also have to be allowed for.

theoretically such a point, but as soon as you bring in the factor of time that point begins to move. It is the movements of that point which are likely to prove important in the short period since it is only after a period of readjustment that a parity may prove itself justified. We must pay attention to the trend of affairs in an essentially dynamic situation.

Thus there are two strands of thought which tend to emerge from any examination of real parity. On the one hand, the more we examine the theory of purchasing-power parity the less satisfactory does it become as a guide to action. Unfortunately, on the other hand, it is quite clear that the choice of parities is extremely important, as a bad choice may call for large changes and readjustments which will be long and difficult and may in the end prove quite impossible.

Under the circumstances the only conclusions one can reach are fairly simple. First, it is important to make what use one can of such rough-and-ready calculations as are available; second, there should be a willingness to experiment with a *de facto* stabilization for a considerable time before any more permanent arrangements come into force; and, third, account should be taken of the comparative position in each country in so far as internal movements of prices and costs are likely to develop, and of the relative burdens of the debt structures. Working along these lines it should be possible to avoid or minimize the necessity for drastic changes.

2. *The Variation of Parities*

A further problem still remains. Assuming that after a period of trial and error, a stabilization on a right and proper basis has been secured, and conditions are more or less normal, when, if at all, is a change of parity justified and under what circumstances? And what form should this change take?

Any change of parity which is not justified by real changes has a greatly disturbing effect. A so-called favourable position in respect of international trade becomes some one else's unfavourable position. Once this is pushed beyond a certain point it forces other countries to do their utmost to correct it. They may try to correct it by reducing further their wages and costs of production, a process prejudicial to general trade activity. They may try to correct it by raising their tariffs, by imposing special duties against countries with depreciated currencies, and by having recourse to quota schemes, all of which will prejudice international trade. Any deviation of the actual exchange rates from the true parity sets up a tendency to inflation in the country whose exchange is undervalued and a tendency to deflation

in the rest of the world. Such a state of affairs is more productive of hoarding, the flight of capital, the growth of all sorts of trade restrictions, than almost anything that can be conceived.

Further, such deviation destroys the basis on which calculation of the relative profitability of enterprise in different countries are based. The result is to slow down the process of desirable international lending. At the same time, there would be a dangerous situation in the short-term money-market: 'bad money' would pile up since alterations of parity of this sort would definitely create speculative opportunities inviting extraordinary transfers of capital.[1]

Arguments of this sort have been extended against all changes of parity. But strictly speaking there is no reason why they should apply to any change which really does restore equilibrium. Where two countries are out of equilibrium at a fixed parity, the mere maintenance of that parity will produce many at least of the disturbing effects which have been indicated. For the time being there may be a papering over of the cracks, but in due course long-term lending will cease and short-term debts accumulate until there is a crash which—if the country is an important one—may develop into a world depression.

The fact that any change of parity should theoretically take account of real changes and not outrun them or fall short of them makes the practical problem very much more difficult. Under a gold standard it would be extraordinarily difficult to make the right adjustments in the relative gold contents of the different currencies. It is probable that the question of the parity would more than ever become a political question. There is the danger that if recourse to this expedient for relieving pressure on the trade balance were to be regarded as the most natural and easy means of adjusting the international position of countries *vis-à-vis* one another, it would become a tempting way of appealing to a democratic electorate. Further, the difficulty of judging what the correct adjustment should be must not be underrated, as the selection of parities is, as we have seen, a matter of the utmost perplexity. It would not be easy for monetary authorities working in an atmosphere of enhanced political feeling to choose parities with accuracy. At least it would seem to be clearly desirable that any changes should be made under the auspices of some international body rather than in the full blast of national politics.[2]

Thus there are strong arguments for making use of the variations of parity as little as possible for the purposes of adjustment. On the other hand, it must be admitted that there are possibilities of dis-

[1] See below, pp. 150–8.

[2] See below, pp. 192–3.

equilibrium arising even under an international standard with fixed parities which starts under the most favourable auspices. The rate of growth in different countries is not the same. It may be that prices should fall slightly in some countries if a continuity of values is to be preserved, while they should remain stationary in others.

'A country in which technical progress is rapid will be able to adjust itself more easily to a lower level of prices (since technical improvements enable it to reduce costs) than will a country where technical progress is slow. But if prices do not fall and wages do not rise, technical progress will bring large profits in its train, and these may lead to over-development in the directions where the largest profits occur. This, again, will not happen where technical progress is slow. At the same time, apart from the technical element, the more complex production becomes the less it can be switched over from one direction to another. The requirements of individual countries are diverging more and more.'[1]

But against this, it is possible that the changes will not be so serious as is sometimes imagined. Economists to-day are still very much oppressed by the unhealthy atmosphere which surrounded post-War development. Perhaps the problem will not be so serious as it has sometimes seemed. Differing rates of productivity may to some extent be offset by changes in the terms of trade. On the whole a free flow of capital should tend to even up the rate of increase in productivity in different countries, but against this must be set the fact that the prospects of such freedom, plus the opportunity of making reasonably accurate judgements, are remote. It is difficult to say how far one tendency may counteract another but, even if under more reasonable conditions a question of this sort may be of secondary and not of primary importance, there may be ample opportunity for disequilibrium to occur before any 'reasonable' conditions are realized.

Any conclusion, therefore, can only be arrived at with caution. It is, however, safe to say that under more normal conditions if parity variations are to be used they should reflect only real changes, and should seek to preserve equilibrium and not to disturb it in the interest of the exporters in any one country. Further, if such adjustments are to take place, it would be desirable for them to be made under the auspices of some outside authority, and not merely depend on a unilateral decision. The latter is a significant point, because if such readjustments are to become a normal and accepted method of preserving general stability the circumstances under which they take place will be important. If they take place in haphazard fashion, they will only make for disorder.

[1] *Monetary Policy and the Depression*, p. 74.

There is one corollary to this argument which perhaps deserves special emphasis. A school of thought has arisen which looks upon the lowering of an exchange parity as an automatic method of forcing up prices. Sometimes the suggestion is made that there is a direct and simple causal relationship between the gold content of a country's currency and its price level, entirely independent of the foreign exchange ratios which that gold content may entail. The argument, taking its stand on a crude version of the quantitative theory of money, would appear to expect prices to double if the gold content of a currency is halved. In this extreme form it is demonstrably fallacious.

But, in fact, as things are to-day there is no reason why prices should rise merely because gold contents of currencies are reduced. They may, of course, rise because of a cheap money policy, open-market operations, programmes of public works, recovery codes, and the like. But that is another matter altogether. Apart from alterations in the foreign exchanges, the only relevant effect of depreciating the gold value of a currency is to increase the money value of the gold reserves of the Central Banks or of other bodies or persons holding gold. This may have important effects when credit has previously been restricted owing to inadequate Central Bank reserves. Alternatively, it is possible to imagine that the increase in Central Bank reserves might be put to constructive use as part of a general scheme of international stabilization. But, such possibilities apart, it is difficult to believe that an addition to the already excessively large reserves of the principal Central Banks would exert any material influence. It is of course possible that the depreciation of currencies in terms of gold would raise prices by persuading speculators and others that they were likely to rise, but it is difficult to believe in the durable efficacy of any influence of this sort unrelated to reality.

The only automatic way in which currency depreciation does raise prices is by raising export and import prices in terms of the home currency. That is to say, the depreciation will have to be that of one currency as against other currencies. If the Australian £ depreciated as against the £ sterling, Australia would get more £ Australian for the goods she exports; on the other hand, if the £ sterling depreciated as against gold currencies, the only result might be a further fall in gold prices while sterling prices remained where they were. We must remember that the countries still on gold represent only a small part of the world's economic activity and play a very minor part in determining world prices. There is something almost ridiculous in supposing that the powerful British and

American economic systems could do much to hoist world prices by establishing lower rates of exchanges with France, Holland, Italy, and Switzerland. Even if we suppose a depreciation of sterling relative to the dollar as well as to other currencies, the results would be little more attractive. By a further depreciation of this kind, if it were practicable to effect it, we could probably secure some small rise of sterling prices because, like ourselves, the United States is an important world market. But against this would have to be set the likelihood of a set-back in dollar prices and a check to the hopes of American recovery. Further, the possibility of a campaign of competitive exchange depreciation would then acquire reality, and it is difficult to believe that anything but mischief could result from such competition.

On the other hand, it is true that a successful unilateral raising of prices may, and probably will, in due course call for a lowering of the exchange in the country where the rise has taken place. But to suggest that the lowering of the exchange rate should come first is to reverse the necessary procedure, and its only effect may be to drag down prices elsewhere more than it raises them in the one country. Recent experiments have only served to emphasize the force of this view. An exchange rate should reflect internal conditions; internal conditions do not automatically reflect exchange rates.

3. *The Use of Exchange Funds*

In these circumstances how is a country to determine if the parity with which it is experimenting is an appropriate one? This problem has arisen time and again in the past and is likely to arise in the future, and it is very obviously a vital one. It can only be answered, first, in terms of the change in indebtedness, and, second, in terms of the internal conditions in the two countries.

It may be assumed that the operations of an exchange equalization fund or of the Central Bank's foreign exchange department will give an indication of the way that things are moving. If the foreign holdings of an exchange fund are beginning suddenly to increase, the possibilities are several. First, it may be that there is an influx of bad money. Second, purely seasonal changes may be at work. Third, a surplus for foreign lending may be available. Fourth, the parity may be too low, and may have resulted in an unduly favourable balance of payments.

All these possibilities will have to be taken into account. The first and the second possibility should be easy to determine. The distinction between the third and fourth is harder to draw, but must be

drawn on the basis of the normal volume of foreign investment as shown by past history, investment opportunities, the total volume of savings available (and desirable) for domestic and foreign investment. Ultimately it rests on the estimate of what the total savings of a country are likely to be in the near future and the relative attractiveness and desirability of investment at home and abroad. If the influx of foreign money is not due to 'bad money', is not due to normal seasonal changes, and is too great for reasonable investment abroad in the light of the above consideration, the parity is too low. The reverse of the argument applies equally. If there is a loss of funds which is not due to 'bad money' leaving, to seasonal payments, to an excess of capital exports, or to a failure of reasonable capital imports, the parity is too high.

All these calculations can only be approximate, but in answer to objections on this score it must be pointed out that the calculation of parities must in themselves be approximate. As long as parity is fixed within a reasonable range adjustments will take place automatically and easily. It is when they are outside these limits that an impossible strain occurs.

There is, however, one conclusion which deserves especial emphasis: the greatest care should be taken to secure exact and detailed figures of the balance of payments in each country. At present most calculations of this sort are very dubious, and anything that could be done to ensure that they reflect fairly accurately what is happening should be of the utmost importance.

CHAPTER XII

THE INTERACTION OF MONETARY SYSTEMS

THE starting-point of any detailed examination of the interaction of monetary systems in the international sphere must be the working of the money-markets of the leading financial powers: Great Britain, the United States, France. Their financial systems follow no one model, and similar features have a very different significance according to the setting. The special problems of other countries—for example, the case of those countries whose balances of payments depend to a large extent upon the world prices of a very few staple exports[1]—must be considered separately. As far as monetary policy is concerned, it is on the action of the large money-market powers that the world situation depends.

1. *Some General Considerations*

The money-markets of the world are constantly acting and reacting on each other. Payments are being made and balances are moving from centre to centre. If the money-markets were perfectly sensitive, a payment by one country would produce an exactly converse effect in the other country. For example, if gold leaves Great Britain and goes to the United States, the effective contraction in Great Britain would be exactly balanced by an effective expansion in the United States. It does not, of course, follow that it would be a good thing that money-markets should always be as sensitive as this ;[2] the important thing is that if they differ in sensitiveness, the authorities must be prepared for any consequences which may arise from this difference. Taking the world system as a whole, a change in one direction in the balance of payments in any one country should be equalled by a net change in the opposite direction in the balance of all the other countries. If the structures of the leading money-markets in fact vary in character so much that a stimulus in one direction in one centre sets up a reaction either greater or less in the other centres, the task of international co-operation is greatly complicated.

It is important, therefore, to assess the relative sensitiveness of the leading money-markets. This sensitiveness depends in the main upon the degree to which each system economizes in its use of cash, and upon the way in which the Central Bank controls and influences

[1] See below, pp. 170–80.

[2] Thus it is harmful if monetary systems become 'sensitive' to movements of bad money. (See below, pp. 155–8.)

the financial system as a whole. A comparison of the banking structure of Great Britain, the United States, and France suggests that the greater the economy in cash the more sensitive the system is in its relations with the Central Bank and the more rapid its adjustment to any stimulus. This economy of cash for internal transaction is probably more effective in Great Britain than in the United States, and certainly more so in both of these than in France. The development of highly specialized commercial banks with very extensive branch systems, together with a good cheque-clearing system, seems to have solved satisfactorily the problem of internal transfer of funds in England. The development of the Federal Reserve system seems to have done much the same thing in the United States. Given such a highly organized transfer system, power to obtain additional supplies of legal tender becomes more important than the actual possession of such legal tender. The greater the technical efficiency of the internal transfer system the greater becomes the sensitiveness of the whole monetary system to the terms upon which it can increase its balances at the Central Bank.

The development of the British system has made it more sensitive than any other to the operations of the Central Bank. The commercial banks never borrow from the Central Bank, and if the supplies of cash are to be increased it comes about through the commercial banks bringing pressure to bear on the money-market and the money-market being forced to rediscount bills. If the Central Bank can quickly, as a result of operations relatively small in scale, influence the terms upon which the banking system can alter its reserves, then the system is in a special degree sensitive to any external stimulus which may compel the Central Bank to operate, or to any action which the Central Bank may wish to undertake. Judged by the British standard neither the French nor the American systems appear as yet to be so sensitive.

2. *The United States*

As we have seen, commercial banks in the United States depend on rediscounting paper direct with the Federal Reserve banks in order to maintain their reserves. The effect of such direct discounting is to introduce an element of play which makes control difficult. As long as there are profitable openings for short-term funds, it pays the banking system to increase its volume of discounts since the reserves cover only a proportion of the deposits created. Conversely, if there are no satisfactory openings for short-term money a commercial bank will reduce the volume of its rediscounts even though the Federal

Reserve Banks are trying to increase the total volume of credit. Thus there is no immediate reaction similar to the reactions in Great Britain.

The matter is complicated in that the market for short money is not in the main bound up, as in England, with bills of one kind or another, but with Call Loans in connexion with the security market. The effect of this is to produce a long chain of causes and effects which sometimes leads to the complete neutralization of the policy of the Reserve Banks. The difficulty is that the Call Loan market, under certain circumstances especially responsive to credit operations, is under others hardly responsive at all. The Federal Reserve Banks may sell securities in order to make credit conditions more stringent. This stringency may cause the Call Rate to rise very high, and this in its turn will tempt the member banks to increase rediscounts and so to neutralize the open-market operations, and may also cause an influx of foreign funds.

There may therefore be a considerable time-lag between a rise in the Federal Reserve rate and a contraction in the deposit creating activity of the member banks, particularly if their deposits are the results of advances to the Call Market, the interest payable on which relates more to the annual rate of capital appreciation of securities than to the annual yield. Ultimately, the Federal Reserve System may make its rate effective by influencing the policy of out-of-town banks whose contraction may affect the dividend earned by concerns whose shares are features of the rising Stock Market. In the end this will reverse the boom and lead to collapse in the Call Market, but there may always be a time-lag between the rising rate and contraction.

Even with open-market operations the system will have great difficulty, if the Call Market is very robust, in making an increase in its rate effective.[1] American Call Rates, as we have just seen, can move upwards to a greater degree than short-money rates in London or other European markets. High Call Rates may be expected, unless other money centres adopt protective measures, to swing the short-term balance of payments in America's favour. This will enable New York banks to import bullion profitably, and these imports of bullion will reduce their dependence on rediscounting and may actually offset open-market operations. Thus the American system is not only cumbrous from the domestic point of view, but may be the source of international disturbance.

During depression control is equally difficult. Reductions in advances coupled with the fall in deposits enable the member banks to

[1] On this see S. E. Harris, *Twenty Years of Federal Reserve Policy*, *passim*.

reduce their reserve requirements. This may make it necessary for the Federal Reserve banks to buy securities if they are to keep their funds in remunerative employment. This enables the member bank to replace debit reserve balances by credit ones. They are then in a position to ignore Central Bank action until there has been a sufficient degree of recovery to make it necessary for them once more to become indebted to the Reserve Banks to fulfil reserve requirements.

But the difficulties of American banking are not difficulties of control alone. Dr. Goldschmidt attributes the weakness of the American banking system to six primary causes:

'1. The absence of a sufficient safeguard against excessive expansion of credit.

'2. The existence of forty-nine different banking systems, leading to a competition in laxity and making co-ordination extremely difficult.

'3. The legal barriers to the development of a system of branch banks, which are a necessity after economic changes have made the exclusive existence of unit banks, usually of very small size, an inherent cause of weakness and instability of the banking system in great parts of the country.

'4. The excessive use of bank credit in financing urban real estate developments.

'5. The close connexion of commercial banks with the security markets, resulting, on the one hand, in a dangerous dependence of the value of bank assets on stock and bond quotations, and, on the other, in an equally dangerous influence of investment bankers on the administration of commercial banks.

'6. The diminishing role that commercial banking in the strict sense of the word has come to play within the American banking system as a whole, and even within the activities of National Banks, State Banks, and Trust Companies.'[1]

At present, under the strain of depression, the whole of the economic system may be said to be in the melting-pot. It is almost certain that big changes will emerge out of the general liquidation. There is likely to be reorganization; probably the influence of the Call Market will be much reduced, and the excessive use of bank credit in financing urban real estate developments discouraged in the future. If these sources of demand for credit play a smaller part, the banking system in general should be more amenable to Federal Reserve control. But to attempt to anticipate what will happen in the United States is an impossible task.

[1] R. W. Goldschmidt, *The Changing Structure of American Banking*, Routledge, 1933, pp. 241-2.

3. *France*

The French system has been characterized by a relatively stable Bank Rate ever since the inception of the Bank of France. The impact of the Bank of France on finance generally before the War seems in the main to have been limited to the provision of such internal transfer facilities as are provided in England by the commercial banks. Apart from the holding of balances needed by Paris banks to meet clearing-house settlement obligations, and apart from public finance, the function of the Bank of France seems to have been to provide, by discounting three name paper, balances that could be transferred at a very low cost to any area of France by means of the network of branches established by the Bank of France. Alterations in the official rate of discount could ultimately influence the costs of all banking services in France and also the liquidity of the private banks, but they only did so very slowly because their influence upon the whole structure of money-rates was indirect. The result was that the monetary system was considerably less sensitive to Central Bank action than the British system.

There are signs that the French system since the War has been developing into something closer to the British model. In order to secure greater economy in the use of cash and, particularly towards the end of the War, to make available for Government financing as large a part as possible of the discount facilities of the Bank of France, there seems to have been a deliberate attempt to develop the use of cheques and so to concentrate the machinery for the international transfer of funds upon the Paris clearing-house and to develop large-scale banking with branches. Evidence of this policy is to be found in the throwing open of the Paris clearing-house in 1918 to banks outside Paris; in the legal provision that exempted from stamp duty all receipt for accounts which have been settled by cheque; and in the tendency for small local banks, which had previously jealously guarded their intimate relations with their customers, to develop the scale of their operations by absorbing other banks in the locality so that they were replaced by branches of larger banks. There has been a noticeable increase in the use of cheques, but the concentration movement is still too young to be finally judged.

The needs of the War confused the issue and may have delayed in some ways the tendency to concentrate. The floating debt and particularly National Defence Bills have been the chief difficulty. To extend the market for these amongst financiers and local bankers they were given special discount facilities. In 1926–7, during the

period of stabilization, an attempt was made to reduce substantially the volume of these bills, but the demand for them remained high and the volume was so large that they offered an alternative to cheque clearing as a means of transferring funds internally. This sort of indirect competition may have delayed the development of the cheque-clearing system. If this is the case, as the effects of War and post-War finance lose their importance, the building-up of French banking upon the foundation of the Paris clearing-house should proceed more rapidly than it has done since 1918. As this happens, the Bank of France will be brought into close relationship with the whole French banking system. This should show itself in two ways. First, the power to build up deposits at the Bank of France will gain a new importance. Balances will be needed not primarily for internal transfer, but to adjust the cash ratios of the whole banking system. Thus the whole money-rate structure will become more sensitive to the cost of building-up and maintaining these Central Bank deposits. Second, the Paris Bill Market will grow in importance as an essential link in the whole system, and will develop upon a surer foundation than in the past.

As soon as these two things have occurred, the dependence of the French banking system on the Bank of France and the policy which it is pursuing will be greater than it is at present. With the growth of the responsibility of the Bank of France, the Bank may be compelled to take powers to employ open-market operations which at present it does not possess. This would be a highly desirable innovation. Until this happens the French banking system will be comparatively insensitive to external stimuli operating through the Bank of France, and any scheme for international co-operation will have to make allowance for this.

4. *National Systems and the International Problem*

As we have seen, before 1914 the international system for making payments functioned successfully for two reasons. First, the gold standard was general, and was worked in accordance with certain elementary rules. Second, this was made possible because the general industrial and commercial position of Great Britain was so strong that the sensitiveness of our system to Bank of England action had sufficient international ramifications to offset the stickiness of the monetary system elsewhere. For example—both in regard to long- and short-term financing—British monetary policy had a tolerably speedy international influence. Crop lifting, not only in the Empire and in South America but also in the United States, was financed

indirectly by London. Crop moving seems to have been mainly financed in London. Hence London bill rates had a more direct influence upon the policy of merchants of primary products overseas than had the policy of their own monetary system. In the same way, as a disproportionate quantity of long-term financing carried on directly by London was for overseas customers, the expenditure and loan policy of foreign Governments as well as the real investment policy of foreign industries were both dependent upon the monetary position of London and on its capacity to export capital. The general economic strength of Great Britain cancelled to a fairly considerable degree the difficulties in the monetary structure of other leading countries.

The continuous economic weakness of Britain since the War has lessened the dependence of the world on short- and long-term financing in London, and has reduced London's power to influence commercial and industrial activities outside Britain. It has therefore made London more sensitive to disequilibrium set up by differences in the speed at which the several monetary systems come into adjustment. Further, it has left the world without any machinery which could keep the various systems in gear.

Thus the provision of any ordered monetary system for the world as a whole must take into account the fact that national systems vary because they have no common history, because they have not grown on the same soil or faced the same rate of industrial development, because the needs which they are called on to satisfy and the attitude of those who are working them vary from one country to another. The great money-market powers of the world do not harmonize in their working—and any arrangements that are to prove lasting must make allowance for the resulting friction. If the international monetary problem is to be solved this friction must either be eliminated or its existence must be recognized; it cannot be ignored.

CHAPTER XIII

SHORT-TERM BALANCES

CONSPICUOUS among the features of international financial crisis is the violent oscillation of short-term capital between different centres, though its importance is perhaps less than many would believe. Movements of 'bad money' are inevitably spectacular, and once they are sufficiently violent they bring spectacular results in their train. Nevertheless, it must be suggested that, contrary to beliefs commonly held, they are definitely controllable through careful management.

The Bank for International Settlements has tried to set out the dimensions of the problem:

'In the second Annual Report, it was estimated that the gross amount of short-term international indebtedness at the beginning of 1931 aggregated more than 50,000 million Swiss francs. On the basis of the data now to hand, it is possible to indicate that this figure was too low if the total gross liabilities of the different countries are added together and no deduction made for offsetting foreign assets, arising for example in the relations between affiliated firms or through one market relending abroad funds which it has itself obtained from abroad. A revised estimate is shown in the following table, in which the figures include financial credits and deposits with banks and similar institutions and also ordinary commercial lending; it should be noted that these statistics refer to the liabilities of European countries and the United States only:

At end of 1930 . . .	70,000 million Swiss frs.
,, 1931 . . .	45,000 ,, ,,
,, 1932 . . .	39,000 ,, ,,
,, 1933 . . .	32,000 ,, ,,

'These totals must be taken to indicate only approximately the main developments that have occurred. It will be seen that the total indebtedness is now distinctly less than half of what it was in 1930, calculated in gold values, and that two-thirds of this reduction took place during 1931. Of the 32,000 million Swiss francs outstanding at the end of 1933 about 11,500 millions is estimated to be blocked through currency regulations, stand-still agreements, and similar measures.

'The different ways in which this volume of short-term international commitments has been reduced, in addition to realized losses due to insolvency, are the following:

'(*a*) By employment of monetary reserves in gold and foreign exchange.

'At some time or other practically every country has had to use part of its monetary reserve to meet capital withdrawals and repayments. In the second half of July 1931 the gold reserve of the Bank of England was

depleted by £30 million. At the end of March 1931, the holdings of gold and foreign exchange of the Reichsbank stood at RM. 2,511 million; three years later they were only RM. 245 million. While the United States acquired gold in 1931, it had to sell gold in the spring of 1932 and again during 1933 in order to meet withdrawals of foreign funds. During 1931 and 1932 the countries later united in the "gold bloc" were, for various reasons, in a position to increase their gold holdings (partly by the conversion of foreign exchange into gold) but when the intermittent waves of distrust spread over Europe, and the propensity to hoard made itself felt, these countries experienced some losses of gold.

'(*b*) By employment of other assets on capital account. Gold and foreign exchange held by commercial banks and other credit institutions have been employed in times of pressure to meet withdrawals of funds; in some instances the monetary authorities have insisted that private institutions should in the first place utilize the assets at their disposal before the Central Bank reserves were drawn upon. As a result of repayments on capital account from various sources, the London market was enabled to pay off a large proportion particularly of the continental European short-term claims upon it. European repurchases of securities from the United States have largely reduced the volume of liabilities of the American market to foreigners.

'(*c*) By employment of a surplus on the current (or income) account. In 1931 Germany realized an export surplus of RM. 2,872 million, which was available for debt service and reduction. As the export surplus vanished, special arrangements have been made for payments through so-called additional exports and tourist expenditure. Similar methods have to some extent been employed in Austria and Hungary.

'(*d*) By consolidation. Arrangements have been made with creditors, as in the agreement regarding the liabilities of the Austrian Credit-Anstalt; in various agreements regarding blocked balances in the Argentine; and in respect of the Central Bank credits to the National Bank of Hungary. Consolidation has also been achieved through loans taken up by new lenders from the proceeds of which short-term credits were repaid (as for example the Austrian International Loan floated in August 1933). Under the Standstill Agreements with Germany, the possibility of using blocked marks for long-term investment is another type of consolidation.

'(*e*) Finally, by depreciation of the currencies in which the debts are expressed. Great Britain and the United States being the largest creditor nations in the world, the depreciation of sterling and the dollar has brought about an immediate accounting reduction in the gold value of international indebtedness.'[1]

Thus to some extent the short-term situation is working itself out and becoming more innocuous.

[1] *Bank for International Settlements, Fourth Annual Report,* Basle, 1934, pp. 27 and 28.

It is hardly necessary to stress the possibilities of disturbance inherent in the existence of a large volume of short-term international indebtedness which may be called at any moment by the creditor in order that he may lend it on short-term again in some other centre. The B.I.S. comment that when 'short-term funds are recalled not with the object of reinvestment at home or elsewhere but as a result of the break-down of confidence, the wholesale demands for immediate transfer are almost certain to break the system at some point. This is what occurred as the sequence to the banking and political difficulty during the year under review,'[1] that is, April 1931 to March 1932.

The questions to be considered fall broadly under three heads—why a large volume of short-term international indebtedness comes into existence, why these credits move from centre to centre, and what can be done to prevent them becoming a disturbing influence.

1. *The Origin of Short-term Balances*

The origins are several. Under normal conditions the volume of short-term indebtedness would grow with international commerce since it would be the outcome of financing that commerce. But this normal and healthy growth is hardly one which need be dealt with at length. It is desirable and, in so far as short-term balances increased owing to the development of international trade in the years before 1929, they are above criticism. But the increase for legitimate commercial purposes must have been small in comparison to the increase due to other causes far less healthy.

The first of these causes was the Gold Exchange Standard. This standard has been unduly criticized, especially by French writers, who have failed to face up to the question of practical alternatives, but there is no doubt that the building of credit superstructures in two or more countries on the basis of gold in one does create a position which, harmless enough under normal conditions, is bound to have very sinister effects as soon as the scramble for hoarding and banking liquidity begins. The criticism which can be directed against the Gold Exchange Standard is not that it is necessarily inflationary, but that it has such tremendous possibilities of deflation as soon as people become frightened of it.

Another cause of the growth of short-term balances was the financial reconstruction of the post-War years, and all that preceded it. Reconstruction involved change on a vast scale and enormous

[1] *Bank for International Settlements, Second Annual Report*, p. 11.

opportunities of profit and loss. Before the stabilization of the franc, French capital had been placed on short term in many centres outside France. These balances were the result of the general disturbance associated with the period. In due course many of them were repatriated.

Other causes must be interpreted in terms of the opportunities existing for profitable short-term investment. There was a demand for short money, and inevitably this demand helped to create the supply. The position in Great Britain has already been described.[1] The needs of Government financing led to a large volume of Treasury bills. This opportunity for profitable investment in short-term Government securities was matched in other countries and was increased by the misdirection of short-term funds to enterprises which, from the economic standpoint, are only justifiable if financed on long term. In addition to the large volume of short-term securities, there were large outstanding issues of long-term securities which were maturing or due for early conversion, and these served the purpose of the short-term investor almost as well as did ordinary short-term investments.

But the opportunities for the profitable placing of short-term funds are not due to the exigencies of Government finance alone. Before 1929—and especially during 1929—the Call Loan Market in New York, financing Stock Exchange speculation, was at moments exceptionally attractive. There is ample testimony to the opportunities in the past of placing short money in the United States in the fact that at periods before 1930 America was a lender on long-term account and a borrower on short.

With depression, fresh forces making for an increase in the volume of international short-term indebtedness come into play. The opportunities for satisfactory long-term investment become strictly limited, and in the circumstances money is held on short term against the day when it may be more profitably placed on long term in new enterprises. This accumulation is only to be expected.

The next cause follows on from the previous one. It is fear, pure and simple, as opposed to lack of opportunity for profitable long-term investment. If your money is placed on short term you have a much better opportunity of getting it out quickly without loss should anything unfortunate happen, and this perhaps is the most dangerous cause of the accumulation of short-term capital.

A final cause of the growth of short-term balances is to be found in the position of London in the years 1925–31. It is now generally

[1] See above, pp. 97–109.

accepted that Great Britain was lending very much more abroad on long term than the positive balance on trading and commercial account, lending long and borrowing short owing to the special conditions that existed at the time. These conditions arose out of the circumstances surrounding our return to the gold standard in 1925. Because our action did much to bring some order into European finance and to make a very substantial contribution to world-trade recovery, the mistaken parity led people to over-estimate the strength of London. We were able to over-lend abroad because we continued to attract short balances.

Surveying all these unrelated factors, it is impossible to say with confidence how far one or the other may predominate in the future. But it is fairly safe to say that none of them (with the probable exception of the last) can be left out of the calculation of statesmen and Central Bankers. In a progressive world moments will no doubt arise when short-term balances will pile up again and threaten the fabric of any financial system that the wit of man may devise. But it seems unlikely—given the absence of war—that they will pile up on the scale that they did in 1931–2. The practical problem is to analyse the reasons why short-term balances move and to discuss the possibilities of preventing such movements disturbing a world economy which already feels none too secure.

2. *Movements of Short-term Balances*

The reasons for which short-term balances move, as distinct from their origins, may be classified under four heads. First, they move to secure an income gain or to avoid an income loss. Rates of interest and opportunities of placing vary constantly from centre to centre. Every holder of short-term funds is naturally anxious to secure as large an income as possible from them consistent with their safety, and he is constantly trying to place them to the best advantage. Second, they move in the desire to secure capital gain or to avoid capital loss. When currencies are fluctuating in terms of each other, more especially when there is a prospect that countries hitherto enjoying stable exchanges may depart from them, there will be attempts to avoid the losses inherent in currency depreciation or to secure gain by placing money abroad or leaving profits there until a currency has depreciated and then bringing it home. Third, there will be arbitrage operations to even out the relationship of various currencies with each other. This falls within the province of professional exchange operators. Lastly, there will be capital movements

as confidence returns and short-term capital is brought back for permanent investment. This is the converse of movements of short-term money to avoid loss. As more normal conditions come about, balances are repatriated.

Surveying these four causes of movements of short-term balances, it will be seen that arbitrage movements can be more or less ignored; they are an ordinary part of the working of monetary systems. The other causes can be divided ultimately into two. On the one hand, there are normal movements due to a desire to secure income gain or avoid income loss; on the other, there are abnormal movements due to a desire to secure capital gain or avoid capital loss, and these in due course are followed by reverse movements when the capital is repatriated.

Thus movements for the sake of income are important only when it can be taken as an hypothesis that there is no danger of the capital being diminished. This is the usual state of affairs under conditions of prosperity with an effective international standard at work. It is under conditions such as these that Bank Rate operates by affecting relative rates of interest in different countries.

Short-term movements, inspired by fear of capital loss or by hope of capital gain, are very different. They are the result of financial panic, and orthodox bank-rate procedure, and tempting income gains are not enough to offset fear of capital loss. At the same time they are peculiarly dangerous because as the run on a country develops so the number of doubters increases, and in the end stability is endangered. The real short-term problem centres on this: the 'bad money' which caused so many difficulties in 1931 and 1932.

3. *The Handling of 'Bad Money'*

The 'bad-money' problem is, as we have seen, a double one. From the point of view of the stable currency it is that of receiving a large influx of funds, of giving them shelter, and then in due course of allowing them to disappear. From the point of view of the country about whose future fears are entertained, it is one of losing money and then in due course of seeing the money return. In both cases the motives behind the movements are extra-economic; they cannot be dealt with—and in fact may only be intensified—through the procedure of deflating in the country losing money and inflating in the country receiving it. The problem becomes one of neutralizing the effect of these movements as far as possible—and this is in sharp contrast with changes in the balance of payments due to the unequal

growth of economic structures, in which case the deflationary and inflationary adjustments would be called for.

The weapons which monetary authorities have at their disposal for dealing with movements of 'bad money' are three. First, they can create a special credit organization on the lines of the Exchange Equalization Fund to take up 'bad money' as it appears and to let it go when it wishes to disappear. By this means creditor countries can protect their own position and also help that of their weaker brethren. Second, a country can put on exchange restrictions. Third, it can vary its parity in such a way as to discourage 'bad money' leaving or coming in. It will be suggested that neither of the last two methods is appropriate to the problem precisely because the movements of bad money may be unrelated to any changes in the real economic conditions of the countries concerned.

The return of short balances is a sign of successful reconstruction. When the franc was stabilized in 1928 short balances returned to France, and once order is restored in the relations between the currency systems of the world, similar movements are bound to occur. When such repatriation of balances comes about, an adjustment of parity will not be the appropriate method of meeting the difficulty. If a country is in the position of holding balances which, for non-economic reasons, are likely to be repatriated without reference to relative movements of money rates in different centres, but with reference to political stabilization, then the appropriate way of meeting such a situation would be by holding a larger proportion of liquid assets equivalent to the volume of balances which may be called away. Since those balances only arrived with a view to remaining temporarily, any policy that aims at holding them in a particular centre against the will of their owners would be mistaken. Variable parities used for this purpose would represent a mistaken policy. It is not the appropriate cure for the particular problem.

A problem of this sort can only be solved successfully through the creation of machinery analogous to that of an Exchange Equalization Fund. If those in charge of such a fund find that over a period of days or weeks there is at a given rate of exchange a surplus on the balance of payments (this will show itself by the tendency of the fund to acquire foreign exchange balances), they will have to consider the reason for this. The rate may be too low, or there may be a true surplus for overseas investment, or there may be a speculative inflow of short balances. If this fund is skilfully operated its gold holdings and its holdings of foreign currency will roughly represent the size of the influx of bad money, and in the event of such money being

repatriated, the holdings of foreign currency and surplus gold will be available to meet withdrawals without putting pressure on the exchange.

The cost of such operations would be small, and would depend on the interest-earning assets held. It would vary in accordance with the proportions held in gold and in foreign currencies, and with the relationship of money rates in the different centres. In the case of Great Britain the cost of such operations would fall ultimately upon the National Exchequer. On the other hand, the return on holdings of foreign currency might well be profitable in comparison with money held at home. But the cost would be well worth incurring, as in the long run it would keep down the cost of financing the floating debt since the withdrawal of foreign balances would not do in the future what it has done in the past, cause a sharp rise in Treasury Bill Rate. The bad money should be allowed to go without destroying confidence. This would best be achieved by a frank statement of policy; that there are certain balances of such and such a magnitude which are likely to be withdrawn and that gold and foreign exchange of an equivalent figure are being held against them. If it would tend to prevent confusion in the public mind, separate figures might be published. Methods of this sort would seem to be the most satisfactory for preventing a repatriation of balances developing into a flight of capital. If the position is inherently sound, there is every reason for explaining how and why this is so. Further, it is probable that in the future the 'bad-money' problem will be much less terrifying than in the past.

There are strong grounds for supposing that the use of parity variations for dealing with movements of bad money will increase the problem rather than make it less. If currency authorities are to have the right to adjust exchanges to deal with currency movements based on psychological rather than economic grounds, it will be essential for the carrying on of international trade of any kind that there should be a considerable development in the futures market in foreign exchange. This becomes necessary because a merchant will have to cover the risk of an adjustment in the exchange parity during the period of any particular transaction. Therefore, one must expect developments in commercial practice leading to a considerable increase in the currency futures market, since merchants will have to cover their risks. As conditions develop under which an adjustment in parity may be necessary, one of the ways in which that will show itself will be a disparity between the spot and future rate greater than justified by the difference in the existing rates in any two

centres. That will proceed to exaggerate the outward movement before adjustment is made, owing to the hope of subsequent repatriation at a substantial profit. This difficulty could be met in part if the alteration in the parity points in any given period never exceeded, as a percentage of the initial rates, the difference between the short-money rates in the centre affected and the chief other centres. But this provision would very substantially remove the benefits to be obtained from altering the parity points. It would seem that the right to move parities would simply keep as a permanent factor in the international monetary system movements of short balances due to expectancies that adjustments were to be made in the parity rate.

There is a further complication in that the effect of parity changes cannot be insulated. The changes under discussion, it must be noted, are being considered as a method of dealing with currency movements due to extra-economic causes. Nevertheless, these changes in parity may have to be on a substantial scale. If that is the case, they will definitely have economic results in addition to the extra-economic results (i.e. the staying of a currency drain), and will affect international trading conditions. Even though these effects are temporary they will be a cause of disturbance. Broadly speaking, we may say that the greater the currency movements that have to be dealt with the greater will be the economic disturbance which will follow from the reaction of changes of parity upon international trade. These arguments, it must be stressed, apply only to changes of parity to deal with movements of short-term funds alone; if there are fundamental underlying disequilibria, the problem becomes very different.[1]

[1] See above, pp. 137–41.

CHAPTER XIV

THE FUTURE OF LONG-TERM LENDING

In the introductory remarks on lending[1] emphasis was laid on several points of significance. The free flow of capital in search of the most profitable returns evened out development in different countries in the pre-War years, and so contributed to the social and economic advance of the world in general. In the post-War years, on the other hand, conditions were confused and the general uncertainty and political influences made it much more difficult for international investment to follow economic criteria. Nevertheless, lending must still be of importance if the world is to have the advantage of the division of labour, of international specialization of productive resources, of the largest and most economic markets. Such was the gist of the preliminary remarks on international lending. It remains in certain respects to elaborate them, and further to assess the importance of future long-term lending and the form that it is likely to take.

1. *The Importance of Lending*

The first presupposition in discussing international lending is the recognition of an international price system. Conversely, the recognition of an international price system presupposes international lending. Within a country lending and borrowing is a continuous process, and must go on if there is to be economic advance. Similarly in an international world one must assume, if there are economic relations between the various trading systems of the world which hold together the price structures of the various countries, some volume of lending across national boundaries. A picture of a world with a uniform price system (though with disturbances in it here and there) must allow for different rates of growth of different countries, for degrees of wealth, for favourable and unfavourable balances of payments (corresponding to needs and developments and to lending and borrowing) which result in surpluses being invested in new capital goods. International investment between countries using different currencies will be inevitable and desirable.

Economic progress in the past was based on differentiation and specialization. If this healthy process is to be carried farther, it must be carried on on the largest possible basis with capital attracted to the points where it is needed most and can consequently secure the highest return. Hence the importance of trying to secure the largest

[1] See above, pp. 117–20.

possible economic system, since that will enable us to provide a higher standard of living and to concentrate production in accordance with the greatest natural advantage. One cannot try to decide arbitrarily whether it is expedient to lend or not to lend; we must recognize the necessity of lending since there are different rates of growth and development in different countries, and these must be kept in harmony if we are to have an international system at all. The problem is not that of deciding whether to lend, but of seeing how to lend wisely.

We must seek, therefore, some solution which will enable loans to be made more reasonable and in more appropriate quantities than in the ten years after the War. During that period obstacles turned out to be insuperable. Price changes and currency changes were on such a scale that international balances were difficult to estimate and were constantly changing, and a further unstable element was introduced by the fact that the United States, the country which by circumstances was put in a position to do most of the lending, had little experience in handling foreign loans and therefore did not do it successfully.

A further point emerges. If there is to be greater national direction and control of investment, it should be directed, not against international specialization and economic intercourse, but rather to support with its full weight the tendency towards specialization in accordance with advantage and the elimination of redundant productive units. Independent national action can only promote stability and progress by stimulating healthy and necessary change.

2. *Post-War Lending*

Post-War lending is often condemned as 'bad lending'. It is important to stress the fact that lending is not necessarily unjustified because in a period of acute and unexampled difficulty many debtors find themselves unable to pay. There are, of course, many sensational examples of lending during the years preceding the depression which have turned out to be completely unjustified. At the same time the sensational exception is certain to receive much wider publicity than a dull and healthy normality. It may be worth while—from the standpoint of Great Britain at any rate—to examine some of the data bearing on the question so often asked, 'Does Foreign Lending Pay?'

Britain's foreign holdings are estimated by Sir Robert Kindersley[1]

[1] *Economic Journal*, June 1933. See pp. 199 f. and 200.

as amounting to, in December 1930, approximately £3,700 million nominal. The distribution was something as follows:

British Empire . .	59 per cent.
South America . .	21 ,,
Europe . . .	8 ,,
United States . .	5 ,,
China and Japan . .	3 ,,
Elsewhere . .	4 ,,

He estimates the income from these overseas investments as follows (the estimate for 1932 is a tentative one):

Income from British Overseas Investments, 1929–33*[1]

(£000's)

	1929	*1930*	*1931*	*1932*	*1933*
Foreign, Dominion, and Colonial Governments and Municipalities	64·7	64·7	65·9	62·4	62·5
British Companies (registered in the U.K.)	86·0	76·5	48·8	42·5	40·6
Foreign and Colonial Companies (registered abroad) . . .	61·7	51·0	40·8	39·2	39·6
Other Investments† (not covered by above)	18·5	16·8	13·2	12·3	12·2
Total . .	230·9	209·0	168·7	156·4	154·9

* The figures for 1933 are provisional estimates.

† The average rate of income derived from these investments is assumed to be the same as that obtained from negotiable securities.

Certainly these figures do not warrant the exaggerated picture which is sometimes drawn of our money being shovelled out to the foreigner and all going down the drain. It is true there is a falling off in income, but that is in the main due to a fall in the earnings of share capital and not to a default. Distinctly more than half of the nominal value of the investment is within the Empire, and the Empire has been very exceptionally free from default. The above figures, of course, do not distinguish between pre-War and post-War investment, and consequently cannot be claimed as proof. On the other hand they seem to suggest that in the case of some of the more sweeping condemnations of foreign lending, pessimism and interested parties have overdrawn the picture of the misfortunes of British investors overseas to an astounding extent. In fact the case—if it can be called a case—is one against investment generally and not against overseas

[1] Kindersley, *Economic Journal*, 1934, p. 377.

investment as such. The Macmillan Committee[1] provide an instructive contrast.

'How easily he [the investor] can be misled in times of speculative fever by glittering—even tawdry—appearances is proved by the experience of 1928, as the following striking figures will show.

'In that year the total amount subscribed for capital issues whether of shares or debentures of 284 companies was £117,000,000. At 31 May, 1931, the total market value of these issues as far as ascertainable was £66,000,000 showing a loss of over £50,000,000 or about 47 per cent. In fact the public's loss has been greater since many of these shares were no doubt sold by the promoters at a high premium. Still more striking perhaps 70 of the above companies have already been wound up and the capital of 36 others has no ascertainable value. The issues of these 106 companies during that year amounted to nearly £20,000,000.'

These companies were mainly confined to the home market, and the Committee draw the conclusion that 'Our financial machinery is definitely weak in that it fails to give clear guidance to the investor when appeals are made to him on behalf of home industry', and contrasts this with the fact that 'when he is investing abroad he has the assistance of long-established issuing houses, whose reputation is world-wide'. Our general post-War experience suggests that the risks of foreign investment[2] are paralleled by the risks of investment at home.

The underlying argument must not be exaggerated. Admittedly there was a great deal of bad lending in the post-War years. Admittedly again the case of Great Britain is not wholly typical; any one desiring to search for striking examples of wasted money would find much more fruitful ground for his researches in the history of the American capital market. At the same time it is clearly not legitimate to draw conclusions against lending overseas as such from

[1] Cmd. 3897 of 1931; para. 386.

[2] Sir Robert Kindersley makes an estimate of the default on Government and Municipal Loans since Dec. 1930.

(£000's)

	Interest.	*Sinking Fund.*	*Total.*
1931 . . .	1,453	1,095	2,548
1932 . . .	9,044	5,413	14,457
1933 . . .	9,544	7,745	17,289
Total since Dec. 1930.	20,041	14,253	34,294

This is substantial, but accounts for only a fraction of the fall in our income from overseas.

a period of exceptional disturbance from which the most experienced lending country emerged surprisingly well.

A further charge against lending abroad is that it tends to finance industries competing with those at home. But even here it would seem as though particular instances have been allowed unduly to dominate the picture.

Nominal Capital invested in Foreign and Colonial Companies; Interest and Dividends received and Loan Capital repaid.[1]

1932

(£000's)

	Share Capital.		*Loan Capital.*		
	Nominal Amount.	*Dividends.*	*Nominal Amount.*	*Interest.*	*Repayment.*
Dominion and Colonial Rails	62,500	1,616	159,600	7,088	227
American Rails . .	18,200	308	9,700	571	. .
Banks	25,600	1,472	18,000	862	258
Breweries . . .	1,300	24	100	5	. .
Canals and Docks . .	1,600	1,946	2,800	1	. .
Commercial and Industrial	63,700	5,613	24,400	1,321	602
Electric Light and Power	15,200	1,023	30,700	1,536	1,095
Financial Land and Investment . . .	26,800	626	25,000	1,013	393
Iron, Coal, and Steel .	6,800	198	10,000	506	62
Mines	56,800	6,975	6,600	462	76
Nitrates . . .	3,000	. .	5,300	226	78
Oil	20,300	140	. .	. .	208
Shipping . . .	6,600	342	800	47	52
Telegraphs and Telephones . . .	6,000	494	10,000	558	31
Tramways . . .	10,600	113	11,200	549	12
Foreign Rails . .	19,000*	1,225*	60,600	2,340	425
Gas			400	22	. .
Waterworks . . .			. .	6	52
Total . .	344,000	22,115	375,200	17,113	3,571

* Owing to great preponderance of bearer securities in the categories Foreign Rails, Gas, and Waterworks, the estimates for share capital and dividends in these three sections are only approximations.

This list does not in itself suggest that the financing of competing industries can have got very far. After all, it is important to remember that over-developed industries are largely a result of the War and of a rather hectic attempt quickly to find substitutes for industries which have suddenly found their products unwanted. It does not

[1] Kindersley, op. cit., p. 374.

pay to finance competing industries unless those competitors have a positive natural advantage. Tariffs are precarious things and the prudent investor overseas might be expected to favour the natural growths of economic development rather than sheltered plants. The above table does not suggest evidence to the contrary. All the evidence points to the fact that the evil of bad international investment is only one among many evils of the post-War period. It has been magnified out of proportion because the slump has overwhelmed many good investments with the bad. Further, much of the post-War overseas investment did not have time to bear fruit with the natural course of development before the slump was upon it—it was a growing crop cut by the spring frost.

Having made this significant general point, it is necessary to examine the changes in post-War investment as contrasted with that of the pre-War period in order to try and assess their significance and the undoubted bad results which in some respects they have brought about. The first important change is one in the character of the investor. The individual with personal experience and large sums of money at his disposal has given place, on the one hand, to a greater number of smaller investors with no experience and, on the other, to the experience of the corporation and trust. This change has had fewer ill consequences in Great Britain than in the United States. In this country the small investor was fairly immune from the fever of speculation, and the Issuing Houses had a long tradition of service and responsibility behind them. As a result the investor overseas has come out relatively well owing to these two facts and to a third fact —that the Empire (a relatively soundly governed part of the globe) was more or less the closed preserve of the London capital market, Canada being the obvious exception. In the United States the position is different. The speculative interest was much greater. The 'high-pressure bond salesman' found a fruitful field in the American public. The standards of Issuing Houses in New York were very much lower than those of the London Issuing Houses, and to a large extent they seem to have been content with passing the bonds on to the public and collecting their commission. The moral responsibility which English Issuing Houses accept in looking after the interests of their clients seems largely to have been ignored.

The second change is shown in the increased volume of bonds in place of equities. This is due partly to the change in the character of the investor (that is, the disappearance of the individual with money and knowledge) and partly to the erroneous view that in a period of disturbance bonds are safer than equities, the true view

being of course that both are risky, the former being little better than a cumulative preference share, while the latter at least have the advantage of being entitled to any windfalls. This demand for bonds may have been largely stimulated—at least in Great Britain—by the growth in the assets of institutions such as insurance companies, who inevitably tend to invest in securities of this sort. It is obvious that changes and chances alter the prosperity of a country from year to year, and there should always be a large amount of equity capital to bear the strain of fluctuations in fortune. In the post-War period it became unduly easy for national and local government authorities to borrow at fixed interest on their own credit and without regard to any reproductive assets that might be created. The result has been that the depression since 1929 not only damaged all equity investments but caused defaults by many governments, impairing their credit for a period that cannot yet be foretold. There is no doubt that any increase in the stream of foreign investment in the years immediately to come should be deflected towards equity investment as against the purchase of bonds.

The third change is shown in the increase in political influence over the volume and direction of foreign lending. Political influence in these matters was not a new thing. Before the War many countries had encouraged loans to friends and allies and had closed their capital markets to their political rivals. After the War, however, political influence greatly increased. In central Europe a great deal of 'reconstruction' lending took place, and loans were being made as part of the price for political settlement and economic concessions. There was a very heavy amount of lending to Germany. A large number of loans were made in central Europe under the auspices of the League of Nations. Without the patronage of the League it seems fairly certain that the risk premium would have been much higher, and in some cases even made the loan impossible. League support enabled the loans to go through, and morally the League was held to be committed at least to giving advice and to keeping a watch on what was happening. Implicitly, if not explicitly, these loans had the approval—and strong approval—of authorities in the leading financial countries. The motives behind these loans were not economic. The deciding factor was not that a loan to this or that country was good because the country was likely to develop its economic resources rapidly and profitably; on the contrary, the loan was to be supported because Governments and Central Banks thought it was a 'good thing' that it should go through, and the investing public was led to believe that 'good things' of this sort ought to pay.

Economic criteria were forced to the background, and to some extent at any rate it is probably not unfair to say that the private investor was left with the task of giving subsidies for desirable objects. Certainly the effect of official influence was to obscure the comparison of relative risks, and not to bring it out more clearly. It is largely the unhappy results (from the investors' standpoint) of official influence of this sort that have contributed to the discredit in which long-term lending finds itself at the present time.

The conclusion which suggests itself is on the whole a fairly obvious one. If future lending is not to bring disappointments (and incidentally not to duplicate existing industries) it must be related much more directly to profit-earning possibilities. Government guarantees are of no help if the economic structure of a country is such that payment is impossible, and in those circumstances the security which guarantees appear to give are illusory. Finally, it is desirable, and probably in the long run more profitable, that the greater part of foreign lending should take the form of the purchase of equity interests and not of fixed interest securities. In this connexion it is interesting to note Mr. Loveday's suggestion[1] that 'it may prove necessary to devise some new form of mortgage security the dividend or interest on which is dependent on profits and constitutes a claim ranking prior to any other dividend'.

3. *The Problem of Control*

Inevitably the question arises, Is anything to be gained by official control or supervision of foreign investment? If this be answered in the affirmative, further questions arise. Under what conditions might control be useful? What form should control take if past errors are to be avoided? The case for control can be argued on two grounds. First, control might do something to improve the quality of overseas lending and to prevent some of the more undesirable features of the lending of the post-War years. Certainly there were—especially in New York—a number of loans floated which a more stringent supervision might well have weeded out. Second, where the balance available on the balance of payments is small the volume of foreign lending might be kept down to the necessary proportions through direct control rather than through the raising of rates by the Central Bank of the lending country.

But there is much to be said on the other side. If the quality of lending is to be improved it may be done through better information, or through a reform of the company and banking legislation, but it will

[1] *Economic Essays in Honour of Gustav Cassel*, 1933, Allen & Unwin, p. 417.

hardly be done by 'control'. There is every reason for the authorities publishing any information at their disposal bearing on the soundness or otherwise of a particular investment so that the prospective investor may choose with knowledge, but there seems little ground for their trying to usurp his function by choosing for him. At present the Stock Exchange Committee in Great Britain, by being able to withhold 'permission to deal', exercise a certain amount of influence, and unofficial advice is given from the Bank of England to those wishing to bring forward a flotation.[1] The argument for official control in order to relate the volume of lending to the balance on international account also appears to fall to the ground if it is to be restricted to the control of new security issues. If new issues are forbidden and it pays to lend abroad, old securities and ownership of existing businesses will change hands instead. Unless we assume that the Government (or whatever other authority will be set up) are going to control the buying and selling of old investments as well, it is difficult to see how any permanent control will work.

The case for control has also been very much weakened by the history of the last few years. As we have seen, a great deal of unfortunate lending is the direct result of Government pressure brought to bear on investors and investing machinery. In Great Britain, it is true, we have enjoyed this good fortune, that the deflection of capital towards the Empire has proved profitable for the private investor. On the other hand, we have no right to assume that this will always be the case, and a time might come when it will be held against a British Government that their influence has tended to direct capital towards part of the Empire in a way which has proved unjustified because it involves investors in losses. Considered from the present standpoint, Empire borrowing has justified itself because the risks were less, not for any other reason.

But if there is a strong case against a constantly working control, there is a good deal to be said for a control coming into force at particular moments, and even more for measures designed to give the fullest publicity to the merits or shortcomings of particular borrowers. Possibly a variable stamp duty might help to tilt the balance in favour of reliable borrowers and to deflect money from borrowers with bad records trying to take advantage of a boom. From the point of view of a Home Government, it must have some power to

[1] There is, of course, the so-called 'Treasury ban' on certain types of new issues. Strictly speaking this is a request and not a 'ban', since it has no authoritative basis, but in fact it seems to be observed fairly strictly—possibly for fear that any new issue disapproved of might be a failure or might involve any firm connected with it in loss of profitable business.

prevent new issues coming on to the market at a moment when it has to make arrangements for dealing with its own commitments. Further, there is no doubt that a control over new issues could at times usefully postpone certain operations. It is true that in the long run it would probably prove ineffective, but it might serve useful short-run purposes. For the long run bank-rate movements would be necessary to control the volume of foreign lending; in the short run artificial action might be a useful addition.

The conclusions which suggest themselves are threefold. First, control as a permanency is hardly likely to prove useful, but temporarily it may prove both useful and necessary, especially during a disturbed period such as the present. Second, lending should as far as possible be related to profit-earning capacity considered in the light of the risks involved, and every effort should be made to clarify the position and not to obscure it. Third—and this follows on from the general argument—any control should be exercised by an impartial body as far removed as possible from political influences of the moment.

4. *The Outlook*

At the present moment international investment has almost broken down. It is not true to say that the flow has entirely ceased, for a certain number of new issues are still being placed on the capital markets of the world, and private companies are also entering into commitments on their own account. Thus the main foreign equity investment at present being made is that being carried out by large companies operating in several countries—companies such as the British-American Tobacco Company, the Dunlop Tyre Company, oil companies such as Shell, and the General Motors Corporation. But there can be little doubt that in time the flow of investment will increase as confidence returns. This may, however, take a long time. India or Australia can make full use of the facilities of the London capital market now; countries in central Europe or South America certainly not. It is precisely among 'defaulters' that the need for capital is likely to be greatest, and the opportunities for securing it smallest. Defaults were plentiful in the pre-War years, but they never reached the magnitude of the present default by Germany, for example. Feeling in the United States is definitely hostile to the countries which have defaulted on War Debts. The Kreuger collapse has set opinion against a form of lending which had inherent possibilities—lending with specific economic assets as security. Bargaining between nations on the subject of the payment of debts has

impaired confidence still further. As long as this lack of confidence endures, the flow of lending cannot increase very greatly.

Nevertheless, it is important that this flow of lending should reach more normal dimensions. Great Britain and other countries have important industries producing capital goods for export, while there are other countries which are in need of capital goods and could use them with success and profit. Only the free flow of capital internationally can bring the two parties together.

But this will only be the case as long as the new investment is spurred on by economic motives and is allowed to bring about the normal result of raising the standard of living first of the less advanced borrower and then of the creditors as well. Unfortunately there is a danger that the time will come when a period of successful lending will be followed by a boom and general excitement, and a feeling that lending for its own sake is both profitable and good. If such a climax is to be avoided, it can only be done through a responsible attitude on the part of those sponsoring overseas loans in big financial centres, and a strong insistence on the significance of the assets which a loan is expected to bring into being.

CHAPTER XV

THE POSITION OF COUNTRIES DEPENDENT ON SPECIALIZED PRODUCTS

THE political assumption that all sovereign states are equal has little force if the position be approached from the economic standpoint. The larger powers, with a diversified economic structure, are much more able to adapt themselves to new conditions than are those countries which for natural reasons have taken to specializing in a narrow range of particular products. The impact of change has much more serious effects in the case, for example, of Chile than it has in regard to one of the leading European Powers. Chile has concentrated on the export of natural nitrates; now she is faced with the competition of synthetic nitrates which has knocked the bottom out of the nitrate market and left her with the task of building up compensating industries without having a substantial basis from which to start. Unless the world is able to provide some technique for helping those countries which have in fact put all their eggs into one basket, it will inevitably happen that in the long run countries will try and limit the degree to which they do specialize. Natural advantages cannot be exploited to the full if the countries which have them are compelled to develop subsidiary industries and to produce goods which could be produced more cheaply elsewhere.

1. *Some General Considerations*

A general characteristic common to most of the countries which have concentrated on special products is that their prosperity is dependent not on the home price but on the world price of the commodities which they produce. Their prosperity cannot be safeguarded by tariffs or by temporary expedients. They are exposed to the full strength of economic disturbance in the world at large.

A further characteristic is that these countries tend to be in need of imported capital, and may further be paying interest on past loans through their exports. The result of this is that when a time of crisis comes they have very real difficulty in maintaining their payments abroad. This is not due necessarily to unwillingness to pay or to political unrest, for these are the result of the collapse of prosperity itself and of the fact that the collapse is all the more severe if there are no alternatives to fall back upon. The one type of country which has most to lose through not being able to maintain its payments in

full is a debtor country of this sort; the inevitable sequel to even a minor financial collapse will be the drying-up of the stream of lending of which the country is probably quite properly in need. Such countries are the victims of the uncertainty surrounding specialization, an uncertainty which, as we shall see, may be of very different kinds.

When we approach the question of the difficulties with which specialized countries are faced, it is important from the beginning to draw one important distinction. Many of the difficulties with which this problem has been surrounded in the past are due to an inability to distinguish between a temporary failure and lasting maladjustment. A temporary failure may be due to a bad crop, or to a passing market disturbance possibly due to slump or to other causes; sweeping maladjustment will occur when technical advance or the discovery of more appropriate sources of supply has made the form which specialization has taken out of date and misapplied from the standpoint of the world economy as a whole. A temporary failure must be bridged, but does not call for large changes in economic organization;[1] wider maladjustments may call for very large changes in the industrial structure of a country.

The method of approach must be entirely different in the two cases, for the technique of tiding over is the exact opposite of the technique of stimulating compensatory developments. To try to change the existing industrial structure when the failure is only transient will be to work for misapplication of capital resources; to try to maintain the existing situation in face of far-reaching misproportion will be to uphold the evil and to postpone the remedies. Diagnosis thus becomes especially important, and the difficulties are all the greater in that in most existing cases something of each method must be applied. The clue to the position must be sought in the forms which specialization has taken within the country itself.

2. *The Temporary Failure*

Examples of the forms that a temporary failure may take occur easily enough to mind. Crops may fail, pests or diseases may for the time being get the upper hand, a large market may collapse for a short period owing to social or political disturbances. For the producing country the result of this may be that its income from its main exports falls off; not only does it find it difficult to meet its debt

[1] Though in the case of some countries hit by slump there is a tendency for small producers to increase production and so to bring on real maladjustment; it is important to prevent this.

charges, but it is probably forced to try to curtail its demand for consumption goods from abroad. In the attempt to pay debts there will probably be various restrictions imposed which affect not only the producing country itself but those from whom it buys.

The problem, however, is that of tiding over a passing difficult period. It must be admitted that the more normal things can be kept the less disturbance there is likely to be and the less will the outside economy be affected. These considerations very definitely strengthen the argument in favour of outside financial support in order to keep things going. To a limited extent such machinery does exist at present, but only in a rudimentary form. It is, for example, probably safe to assume that were some pest or disease to destroy in one year the main crop of any British Dominion or Colony, financial interests in London, official and unofficial, would go quite a long way to prevent obligations maturing in that year becoming burdensome. A certain amount of support there very definitely would be, and this support would in all probability be very considerable were the financial interests at home really convinced that the trouble was a passing one and not due to 'extravagance' and bugbears of that sort. But the relationship between London and the Empire is an exceptional one.

There is little of such machinery to tide over temporary failure in other parts of the world, though the support given by London banks to those in difficulty abroad is sometimes not inconsiderable.[1] What is needed, and this applies only to *temporary* failures, is a technique of providing relief from obligation for the time being; such a technique can only be developed successfully on an international basis through an international machinery.

Of necessity the amount that the country itself can do is limited. With the inability to meet external obligations the tendency will be for the exchange to depreciate. Restrictions of various kinds may be imposed to support the exchange, but these are unlikely to prove effective where the country is strongly specialized and outside support is lacking. If there is some element of support it may be possible to maintain the position by some such device as a tax on imports and a subsidy to exports. A device of this sort does on the whole tend to spread more evenly the incidence of depression in the country concerned, but it is a palliative which can only prove effective where the position has not got out of hand. With collapse there will be a tendency—assuming an absence of outside support—for the exchange to depreciate.

[1] e.g. the London bank loan to the Banco de Brasil.

Thus the chief thing to be remembered in the case of temporary failure on the part of a country dependent on specialized products is that any undue straining in attempting to meet external obligation is likely to mean a worsening of the position both in that country and elsewhere. The duties of creditors towards their debtors have tended in the past to be interpreted very narrowly, especially in the case of those creditors inexperienced in foreign lending. Without support, temporary failures must gather strength—and tariffs, restrictions, defaults, and currency depreciation are the consequences which are to be anticipated. But a more liberal creditor policy based on the assumption that bad periods are balanced by good ones—as, in fact, they tend to be—would enable disturbance to be minimized. The chief difficulty here is not the absence of goodwill but the absence of an effective and trusted machinery. Without an appropriate mechanism not only is organization difficult, but individual creditors are always afraid to make any concessions themselves since they may go to the advantage of others. The dislocation which occurs owing to the temporary failure of a main export crop can only be minimized on the hypothesis that creditor countries are prepared to co-operate and are willing to make use of machinery existing or created specially for the purpose.

3. *Permanent Readjustments*

Much greater difficulty surrounds the question of permanent readjustments. Changes are constantly going on; improved methods may set free a portion of the population to satisfy other needs; technical achievements may give the natural advantage to some new competitor. Over-production may occur, and the price of the product will remain far below the profitable level until productive capacity is reduced. In these circumstances fundamental economic changes are called for. Thus Denmark is trying to find alternatives to bacon; Chile is developing copper and gold in place of nitrate; Brazil is developing live stock in place of coffee, as it developed coffee in place of rubber when natural rubber became unprofitable with the growth of plantation rubber.

In such cases the fundamental need is the development of alternative productive activities. The development of such activities will call for an import of capital on a considerable scale since the possibility of making savings out of the depressed main industry is ruled out owing to the fall in prices. Unfortunately, it is precisely at a moment such as this that everything seems unprofitable and the flow of new capital will consequently be small. Appearances are such that

this flow is at its lowest at the moment when it is most needed and when, in theory at least, investment should be most profitable on account of the availability of unemployed labour and land.

It need hardly be said that there is no remedy for such a position by treating it as if it were a temporary bad patch which had to be tided over. Any bolstering-up of the position will only make things worse. What is needed is new development, and such development must be financed.

There is one difficulty which in these circumstances new financing must encounter. The country will have been burdened with a heavy weight of past obligations. Foreign capital will always be suspicious if its owners feel that any successful industries they may set up will be saddled with the task of paying for the past borrowings of the Government which has spent large sums of money on services complementary to the failing industry, even if it is not financially involved in the industry itself. The story of the depressed areas may repeat itself on a world-wide scale. New industries are developing round London rather than replacing old industries in the depressed areas in the North, partly because until a few years ago new industries in the North would have had to meet heavy rate burdens contracted in the interest of their failing predecessors. A country whose staple exports are no longer wanted will find considerable difficulty in developing alternative forms of economic activity if she has heavy debt burdens hanging round her neck.

Generally it follows that, except where maladjustment is on a fairly small scale, Government credit will not be sufficiently strong for it to be able to borrow from abroad at reasonable rates. The country will be forced to seek the support of foreign business concerns, or of collectively organized outside loans; and the prospects of the latter are remote except where vested interests have succeeded in pressing Governments to give support in an attempt to save money already invested. That type of support is undesirable in so far as its result is to saddle the new industries of the future with the burden of an unamortized past.

Under these circumstances there is a natural tendency towards currency depreciation, since if this is effected the weight of internal fixed interest debt will be reduced and there will be a stimulation of profits in alternative lines. Further, if the world price remains where it was, profits will be increased to that extent, while if the world price falls, an increase in exports may prove a compensating factor. Undoubtedly this is a form of readjustment which has its uses, though they are limited. It does nothing, for example, to reduce the weight

of loans expressed in the currency of foreign countries; on the contrary, it increases it. Currency depreciation is only a substitute for default where the loans are expressed in terms of the depreciating currency, and in any case future loans will be all the harder, and in all probability will require to be heavily secured.

It may be said that the needs of a country which has specialized its resources in one or two particular directions and then finds the demand failing are not unlike those of a private firm in the same position. Limited liability and the right to 'reconstruct', where the Courts are satisfied that such reconstruction is necessary, are a method of preventing the past from keeping a dead hand on the future. International practice has no counterpart of this, apart from default and long and tedious negotiations. The process of reconstruction is held up, and new investment and new capital have to wait. The possibility of an 'international bankruptcy court' which will deal with questions of this sort may be remote, but there is no reason why an accepted international practice of settling debt questions through arbitration should not grow up.[1] The appointment of official liquidators for Governments—if hardly flattering to sovereign rights—would certainly have enormous economic benefits if it prevented debt questions from hanging on and delaying necessary changes through uncertainty. In the international field rigidity of an economic structure is often due to the fact that questions of capacity to pay have not been taken out of international politics.

Apart from this, any policy is useful which serves to attract new capital and make such developments profitable. Government action should be directed towards this end, aiming at the shifting of the factors of production from the old commodities to the new. The quicker the change-over can be made the shorter will be the period of dislocation.

4. *The Case of Australia*

Developments in Australia during the recent depression are of especial interest, for Australia is dependent on the export of a few specialized products, wool, wheat, and metals, while her financial difficulties have been handled with a success which at one time appeared quite out of the range of possibility. The following account is taken from two articles[2] by Professor Copland, who played a big part in the formulation of the so-called 'Premiers' Plan'.

[1] See below, pp. 192–3.

[2] Douglas Copland, 'The Premiers' Plan in Australia' (*International Affairs*, Jan.–Feb. 1934) and 'Economic Adjustment in Australia' (*Lloyds Bank Review*, Nov. 1933). See also E. R. Walker, *Australia in the World Depression* (London, P. S. King, 1933).

The slump struck Australia early, with a fall in the price of her main exports. As depression deepened, more and more concern was felt:

'There was a deep-rooted conviction in many quarters in Australia that real costs were too high, and that government expenditure was on too extravagant a scale. To have attempted to reduce these costs by inflation in a world that was deflating would have quickly sapped confidence in the currency and the financial structure. Thus the inflationists would have been defeated even if their solution were theoretically sound. Though more familiar, the proposals of the deflationists were quite inadequate. The adjustment was too great for the partial action vaguely recommended by this school. Both political and economic obstacles were fatal to their views. An all-round reduction of costs on a grand scale required the correct political setting, while any action that left fixed costs a greater relative burden than ever was clearly inappropriate.'

Eventually a middle course was adopted, the so-called 'Premiers' Plan'.

'The economic problem in brief was to adjust the economy of the country to a loss of national income that had fallen with special severity on some sections of the people, and was gradually causing distress to all. Primary producers were most severely affected because their incomes were exposed to the full blast of the fall in export prices. By the beginning of 1931 the fall had reached 50 per cent. on the 1928 level, and it was even more severe in the great pastoral industry. The sudden cessation of long-term borrowing abroad had caused a great contraction of public works with increasing unemployment. From both these causes of direct loss of national income, indirect losses to secondary production were mounting up with consequent increase in unemployment. At the same time the profits of industry as a whole were languishing. Thus three types of income had suffered; income from export production, income from public works employment and income from profits. To this was being added a fourth class; income from industrial production that was suffering from the reduced demand of primary producers and governments in respect of their loan expenditure. Meanwhile the Commonwealth Government in its zeal to reduce imports had greatly increased the tariff and was using up the gold and overseas exchange reserves of the banks to meet national obligations. The exchange rate, though moving more and more away from parity with sterling, was throughout 1930 pegged below the level of the "black" market. Hence the farmer was denied the relief that would have come from higher local prices in a more depreciated currency, while the goods and services that made up his costs were protected by higher tariffs, a somewhat rigid wage structure and fixed interest and rent charges.'

The economists responsible wanted the burden to be shared by all classes. They took the view that on account of the fall in the prices

of exports 'some exchange depreciation was necessary, that fixed charges had to be adjusted', and that 'a fall in the standard of living as a whole was inevitable'. Under the pressure of events the £ went to a discount on sterling, and later when Britain went off the gold standard the position was further eased. In December 1931 the rate was fixed at £125 Australian for £100 sterling, and is now pegged by the Commonwealth Bank. 'There can be little doubt that the depreciation of the currency has had beneficial effects in transferring some of the losses of income from export producers to the community as a whole.'

Next came wage reductions. First the Commonwealth Arbitration Court (and later the Courts of the other States) gave decisions reducing the basic rate of wages. By the end of 1932 wages were down by about 30 per cent. on the 1928 level. The arbitration system, Professor Copland suggests, had worked much better than was expected, and wages had shown themselves flexible.

The Government finances had been in difficulties, and drastic retrenchment followed there. In addition to the cut in wages and salaries there was a cut in interest. The Plan adopted covered

'a conversion of the internal debt of £556 million from 5¼ per cent. to less than 4 per cent., a reduction in expenditure on the lines suggested by the Committee, an increase in taxation but not to the extent urged by the Committee, and a reduction of 22½ per cent. in private interest and rent. The legislation was passed by the Commonwealth and State Governments and by the end of August the conversion loan had been successfully floated. Only 3 per cent. remained unconverted, and this was for the most part compulsorily converted later. The other measures were passed largely according to plan, though there were differences in details. The results on the budgets were on the whole satisfactory, though not up to the improved figures mentioned by the Committee. The year ended with combined deficits of £18 million instead of £13 million as originally desired. In part this result was caused by the further fall in export prices, and the general depressing effects of the world crisis. At a subsequent conference in July 1932 further steps were taken to reduce deficits, with the result that in 1932–3 they were brought down to less than £9 million for the States against sinking-fund payments of more than £7 million. But the Commonwealth Government had a surplus of £3·5 million. I should add that this surplus was obtained after a reduction of taxation and a special increase in expenditure amounting in all to £3·25 million.'

Bond prices soon rose, and unemployment fell.

All the elements discussed—with the exception of currency depreciation—are deflationary. To counteract this, Government expenditure was to some extent financed by the banks.

'Up to May 1931, the banks had furnished large credits to the governments for deficits and loan works. The Plan recognized that this method of finance should continue on a gradually declining scale. At first it was the growth of the credits for external obligations that caused most concern. At one time these external credits, including British treasury bills, amounted to £38 million. With the use of Australian gold and foreign exchange reserves, the external floating debt, now £32 million, is in the hands of the Commonwealth Bank, except for less than £4 million held by a British joint stock bank. The existence of such a large amount of Australian Governments securities maturing abroad has to some extent frozen the assets of the Commonwealth Bank, but as the external position of Australia improves, these credits will become more liquid. Internally the floating debt expanded rapidly from £20 million at 30 June 1931, to its maximum of £51 million at 30 September 1932.[1] This rapid growth of the internal floating debt caused some misgivings among bankers, but it is really in strict keeping with the general plan of recovery. Much of this debt was made possible by the expansion of Central Bank credit through the Commonwealth Bank, and it had beneficial effects in counteracting deflationary influences embodied in other aspects of the Plan. The increase in the floating debt caused an expansion of private bank deposits, an increase in the funds on the money-market, and a reduction in rates of interest. To have borrowed in the open market for deposits or loan works would have hardened rates of interest, as was proved by the premature loan of November 1932. Interest rates, however, fell rapidly after the middle of 1930, as already indicated, and the treasury bills offered an avenue of investment for the banks at a time when the demand for advances was low. The bills now bear interest at 2½ per cent., while the rate on bank deposits has been reduced to 2 per cent. for three-months deposits and 3 per cent. for two-year deposits. Now that these low rates of interest have been established, it is possible for the necessary funds for loan works to be raised on the open market.'

Professor Copland adds the comment, 'the growth of the floating debt must therefore be looked upon as one of the aids to recovery, and not as a menace to sound finance'. He considers that the expansion of credit was necessary to counteract the deflationary effects of the reductions in prices and incomes.

'The banking policy of Australia was sound in the crisis mainly because it was less orthodox than that which so-called sound financiers would readily pursue. Indeed, it is not unreasonable to say that the success of the Australian plan lay in its neat balance of orthodox and unorthodox measures. The deflationary elements created confidence in the capacity of the governments to make the necessary adjustments. The inflationary

[1] It fluctuated round that level to March 1933, but has fallen since to £48 million. (Beginning of 1934.)

elements prevented these deflationary forces from causing further slackening of enterprise, and laid the foundations for financial recovery, which always precedes economic recovery. . . . Australia's main mistake was that she did not depreciate her currency sooner and tackle her budget problem earlier'.

The budget problem is more or less solved, and export prices—especially of wool—have improved, and Australia now seems well on the way to recovery.

Professor Copland summarizes the policy as follows:

'(1) A reduction in real wages, determined by the Commonwealth Arbitration Court.

'(2) Reductions in government expenditure and increases in revenue.

'(3) Reductions in interest, both public and private, and in rents.

'(4) Expansion of Central Bank credit to finance deficits and necessary loan works.

'(5) Depreciation of the currency to correct the balance of payments, assist export producers, and sustain the internal price structure.'

5. *The Trend towards Self-sufficiency*

Though the case of Australia is an interesting one, the conclusions that can be drawn from it are limited. Australian depression began with a fall in the price of wool and ended with a rise in its price; the picture would have been very different had wool been in the same category as sugar or rubber or Chilean nitrates. The Australian example is important because it does show what an active policy can do. But it does not throw very much light on how to deal with major dislocation.

And it is a fear of such dislocations that is warping economic development at the present time. All over the world there is a strong movement towards what may be roughly defined as 'national self-sufficiency'. Economists point out, with truth, that such a movement, by cutting up and reducing the size of markets and artificially stimulating superfluous developments, is working against the fullest specialization of natural resources and so reducing mankind's real income. The force behind the arguments of economists cannot be denied; yet under existing conditions the trend towards self-sufficiency seems almost inevitable. Specialization has its dangers for nations as it has for its individuals; and nations cannot receive an unemployment allowance to enable them to bridge over the gap between the failure of one type of economic activity and the inception of the next. It is useless for economists to argue that the world as a whole will be better off with greater specialization when that

specialization may bring disaster to individual countries. The inducements that economic theorists offer are as unsatisfactory as suggesting to a man that if he takes a particular line of action he may be and his fellows certainly will be richer, though there is a considerable risk that he and his family will starve. The problem which theorists and practical men alike have to solve is that of combining the widest specialization with 'economic security'. This is the fundamental international economic problem of the twentieth century.

CHAPTER XVI

INTERNATIONAL MONETARY CO-OPERATION

At various points in the preceding pages reference has been made to the necessity of securing effective international co-operation in dealing with particular aspects of the monetary problem. The difficulties which such co-operation is designed to overcome, and the methods of approach to be adopted, differ to a very considerable extent. It is now time to examine some of these aspects of co-operation in greater detail and to relate them to such machinery as already exists —rudimentary though it may be—for the organization of a policy in which several countries are collectively taking part. This machinery at present centres on the Bank for International Settlements and the Financial Section of the League of Nations.

1. *Aspects of International Monetary Co-operation*

To simplify the approach it may be convenient to consider international co-operation in two different settings, first, under normal conditions, and second, under conditions of emergency. Such a classification is in some ways artificial, but has sufficient force to justify it. It is true that even under settled conditions somewhere in the world there will be emergencies and potential emergencies, but the policies to be adopted will clearly be very different in a period of reasonable trading conditions and in a period of general incipient collapse.

Under normal conditions the first significant aspect of co-operation is that of seeking to secure a co-operation of Central Bank policies in order to prevent undue fluctuations in general values. To a very large extent this was the gold problem—the problem of seeing that the effective increase in monetary gold does not outrun or fall short of the world's requirements. In the absence of gold the problem remains much the same, that of relating the increase in credit to the world's needs.

The second question is that of international clearing arrangements. International claims are constantly maturing in different directions, and an efficient world-clearing organization could do much to cancel claims one against the other if they mature within reasonably short intervals of each other. There are, for example, regular seasonal fluctuations in balances of payments which before the War led to rhythmic movements of gold, outflow being followed by inflow and inflow by outflow. Such payments could readily be met through an efficient international book-keeping system, and to this extent gold

movements, for example, reduced. In fact, as we shall see, they have been to a large extent simplified through the setting up of the Bank for International Settlements and through the increased tendency to earmark gold instead of moving it.

The third aspect is closely related. It has been emphasized that the large money-markets of the world are irregular in their working.[1] Under the post-War gold standard a payment from one country to another did not always mean that the destruction of means of payment in the paying country was exactly balanced by an increase of means of payment in the lending country. These unequal reactions have given rise to friction.

These three aspects may all be classed under the heading 'Normal'. Next, international action must be considered under emergency conditions.

First, there is the question of short-term emergency financing in the case of a country suffering a temporary failure—a country which is likely to recover quite easily, once the crisis has passed. This is an exceedingly important problem since lack of support may mean, first, that the disorder may spread and, second, that a country dare not specialize to get the full benefits of its natural advantages if it has to diffuse its economic activity in such a way as to guard against transient difficulties. The subject has already been discussed in a general way at some length.[2]

Second, there is the 'Bad Money' problem and the demand for liquidity, with which it is associated, during a period of economic crisis. As confidence departs people tend to do their utmost to keep the money claims in such a form that they can use them quickly and transfer them from centre to centre as their fears change. This problem is a technical one, which becomes especially conspicuous in the form of 'runs' on particular currencies. The danger can be prevented by increasing the certainty that all claims will be met. Thus the only method to deal with such a problem is, as we have seen,[3] to mobilize resources in such a way that as people sell claims in one currency their claims are taken over without strain.

Third, comes the question of what might be described as 'readjustment' financing on long-term in the case of those countries whose economic structure is out of joint whether owing to wars, to technical developments, or to other causes. This is the problem of providing capital for the compensating industries which replace the original industries now in a state of decay.

[1] See above, pp. 143 and 144. [2] See above, pp. 171–3.
[3] See above, pp. 155–8.

Fourth, there is the need for some institution able to suggest an equitable basis of settlement for outstanding debt questions and for other international financial disputes. When a nation is unable to pay its debts, what it needs above most things is a quick settlement which by writing down past debts makes the way clear for future borrowing which will make possible new developments.[1] Any delay in the adjustment of past claims means that economic conditions are drifting from bad to worse. Some machinery is needed which will settle debt questions and questions of new parities with the minimum of delay.

It now remains to consider these questions in relation to existing international financial and economic institutions, in particular in relation to the Bank for International Settlements.

2. *The Bank for International Settlements as a Working Institution*

The Bank for International Settlements commenced business on May 17th, 1930. Its capital was subscribed by leading Central Banks and by banking groups from the United States and Japan, where legal or political considerations prevented the authorities themselves from taking a direct part. The number of Central Banks was added to as time went on, and at present twenty-six banks and groups are represented among its shareholders.[2]

The objects of the B.I.S. are defined by Article 3 of its Statutes as being: 'to promote the co-operation of Central Banks and to provide additional facilities for international financial operations; and to act as trustee or agent in regard to international financial settlements entrusted to it under agreements with the parties concerned.' Thus the Bank's functions may be classified under two heads. It had the general task of promoting international financial co-operation, and in addition it had the specific task of dealing with the War Debt and Reparation payments which were bulking so large at the time. The disappearance of the Debt and Reparation payments from the international sphere leaves the Bank with only its more general functions to consider.

The resources of the Bank were frs. Swiss 667,525,929·98 on March 31st, 1934, though they had been much larger when the various debt payments were at their height. At the same date the paid-up

[1] See above, pp. 173–5.

[2] The countries represented are (1934) Great Britain, Belgium, France, Italy, Germany, Japan, U.S.A., the Netherlands, Switzerland, Sweden, Danzig, Finland, Greece, Austria, Bulgaria, Denmark, Rumania, Poland, Hungary, Czechoslovakia, Estonia, Latvia, Lithuania, Albania, Norway, and Yugoslavia.

capital was frs. Swiss 125,000,000 (25 per cent. paid up on frs. Swiss 500,000,000) while the reserves were frs. Swiss 13,706,161·82.

It is striking how small these resources really are for playing any dominant part in important financial affairs. This is forcibly illustrated by a comparison with the resources of the Exchange Equalization Fund in Great Britain, which has some £375,000,000 at its disposal. Reckoning at frs. Swiss 16 to the £ this is equal to frs. Swiss 6,000,000,000. The resources of the Exchange Equalization Fund are nearly ten times as large as the total deposits of the B.I.S.

It is an obvious comment on the weakness of the B.I.S. as an international co-ordinating agency. When it is realized how weak financially the Bank really is, it is not surprising that it has been able to play no very great part in combating the financial collapse which coincided with the first few years of its existence. The surprising thing is not that it has done so little, but that it has done so much with the very scanty ammunition at its disposal. Clearly, if the B.I.S. is to play any extensive part in world affairs its resources must be increased.

There are other limitations on its activity, though none of them are as hampering as its lack of resources. Article 26 lays down that

> 'The Bank shall be administered with particular regard to maintaining its liquidity, and for this purpose shall retain assets appropriate to the maturity and character of its liabilities. Its short-term liquid assets may include bank notes, cheques payable on sight drawn on first-class banks, claims in course of collection, deposits at sight or at short notice in first-class banks, and prime bills of exchange of not more than ninety days' usance, of a kind usually accepted for rediscount by central banks.
>
> The proportion of the Bank's assets held in any given currency shall be determined by the Board with due regard to the liabilities of the Bank.'

While such a provision may seem harmless and even obvious during normal times, if it is interpreted too narrowly it ties the hands of the Bank in relieving financial stringency. The B.I.S. must be free to utilize its resources and go to the aid of any country threatened by international financial panic. The knowledge that it is free to do this, and that it is prepared to do so with the large funds at its disposal, will in itself be a stabilizing influence. Once people know that a currency as a matter of course will receive strong support, the panic subsides. It is only when the support is an unknown or a doubtful quantity that panic is dangerous. To take a parallel, no one fears for the British commercial banks because it is a matter of common knowledge that the Bank of England will put unlimited

means at their disposal if there is a run on the banks. In the same way the B.I.S. could play a big part in minimizing international financial panic. But it cannot do much if its means are limited and its freedom of action restricted.

Another limitation is that 'The operations of the Bank for its own account shall only be carried out in currencies which in the opinion of the Board satisfy the practical requirements of the gold or gold exchange standard' (Art. 21). Such a limitation, though it may have seemed natural when it was drawn up, has a definitely old-world air at a time when the international gold standard has broken down over the greater part of the world. It can only prove hampering at present.

Under these conditions the B.I.S. was quite unable to deal with the panic currency movements during the recent depression. If it was to conserve its assets at a time when country after country was going off the gold standard, it had to keep a close watch to ensure that its liabilities in one currency were more or less balanced by the assets held in that currency. This at once restricted the scope of its operations very severely.[1]

3. *International Clearing Problems and the Relation of Money-markets*

The problems with which any international monetary agency would be faced under more or less normal conditions were classified under three heads. The first of these, in effect that of international credit control, is best left aside for the moment. The two remaining problems are those of international clearing operations, and of coordinating the work of money-markets so that a reasonable outflow from one monetary system is balanced by a reasonable inflow into another.

The B.I.S. is in theory adequately equipped to deal with such problems. Its success in dealing with the mechanical operations involved in debt and reparation clearances has already been mentioned. It can deal equally well with, for example, seasonal fluctuations (provided they are true seasonal fluctuations) once its experience

[1] Certain specific things which the Bank may and may not do are laid down in Articles 22 and 25. The Bank is free to deal as it likes with gold coin or bullion, operating either for its own account or for the account of Central Banks; it can make advances to, or borrow from, Central Banks on approved security; it can deal in foreign exchange, buy and sell securities, discount and re-discount bills, and open accounts with Central Banks as well as receiving deposits from them and from certain other recognized agencies (e.g. under Trustee agreements in connexion with international settlements). It is debarred from issuing notes, 'accepting' bills, dealing with Governments, and going into business.

has enabled it to judge the nature and dimension of such seasonal flows in payments. In fact, there is every reason to believe that it has aimed at doing so and in this way has minimized the necessity for gold movements.

Similarly its experience should enable it to co-ordinate the working of international money-markets. Once it is able to judge the effects of payments between different monetary systems it should be in a position to allow for any time-lag, to prepare the way for payments, and to strengthen or damp down any reactions which occur.

But the hypotheses of normality are not very helpful. One can safely conclude that were the resources at the disposal of the B.I.S. adequate, and they are not, it could do a good deal to eliminate friction when monetary systems are working freely and easily and without strain. But machinery which will work only under fair weather conditions is of secondary interest; of greater interest is machinery which will work also when the prospects are clouded.

4. *The Emergency Short-term Problem and the Bank for International Settlements*

Under emergency conditions the new technique which the B.I.S. represents is both useful and important. At the same time it is quite clear that it did not play, and could not possibly have played, the part in dealing with conditions of international financial panic which some of its sponsors might have hoped. Within its limits it did a great deal, but these limits were very narrow, and consequently it is probably fair to say that it did more through bringing Central Bankers together at regular intervals than it did through the direct use of its own resources.

It was fully aware of these limitations, and consequently it organized help from outside as well as giving direct help itself. Assistance given is described in the Second Annual Report, in discussing the sweeping withdrawals of short-term credit from central Europe and Germany.

'Emergency help was imperative to enable the affected Central Banks to face the drain; and to give a breathing space both to debtors and creditors during which measures might be taken to withstand the shock; and to attempt to consolidate their positions. In rapid succession the Bank for International Settlements was called upon to grant emergency credits to the National Bank of Hungary, the National Bank of Austria, the Reichsbank, the Bank of Yugoslavia, and a temporary advance to the Bank of Danzig. The call came at the very moment when the natural effect of the Hoover proposal was to lessen the existing and prospective

working resources of the institution derived from inter-governmental payments. In consequence, to amplify its possibilities of material aid and in close collaboration with Central Banks, the Bank for International Settlements organized syndicates of Central Banks which contributed funds to the common constructive cause. Thus, three Central Banks, besides the Bank for International Settlements, participated, to the extent of $25,000,000 each, in the credit of $100,000,000 to the Reichsbank, and twelve Central Banks, besides the Bank for International Settlements, participated in the credits of approximately $26,000,000 to the Hungarian National Bank. Further reference to this second phase of the year's work, that of emergency credit-granting, appears below in connexion with a review of the short-term credit situation and its effects. At no time were these credits regarded as remedies, but merely facilities giving the chance for corrective or defensive measures to be taken. Yet without them, and without the opportunity which the existence of the Bank for International Settlements afforded for speedy consultation and joint action between Central Banks, it is a matter for conjecture whether the acute credit crisis would not have been still more catastrophic and would not have resulted in a swifter and wider immobilization of the large creditor markets, as well as of those of their debtors.'[1]

The Bank emphasized the extent of the emergency help granted during the year 1931. 'If there be added together the total amount of external advances granted by Central Banks, by the Bank for International Settlements, by the principal capital centres, and by Treasuries, including the sums advanced to the British market, a figure of approximately 5 billion Swiss francs is reached, or about one-tenth of the total amount of short-term indebtedness outstanding at the beginning of 1931.'

It has further been suggested that when the problem of reconstruction comes up the Bank may play an exceptionally large part. The idea of a 'currency normalization fund' worked by, and under the direction of, the B.I.S., has been put forward. Such a fund would be of use

'for the purpose of assisting at the opportune moment the normalization or final regularization of currency conditions in Central and Eastern Europe.

'In the minds of the authors of this suggestion, the fund would operate in the following manner:

The immediate object of the fund would be to assist Central Banks by increasing their reserves at the opportune moment. It would therefore be concerned with currency matters.

'It would not be called into play until the last stage, and would, as it were, form the coping-stone of the edifice raised by the interested parties

[1] Op. cit., p. 8.

themselves. But the conditions necessary to its employment might perhaps be satisfied more rapidly in some countries than in others; in any case, it is to be hoped that this would be brought about at the earliest possible moment.

'Everything considered, it would be desirable that a movement for promoting the idea of such measures should be launched without further delay as its value in stimulating confidence might be immense. In the countries of Central and Eastern Europe, the psychological factor is of exceptional importance on account of the impression left on the public mind by the currency disaster of a few years ago.

'In the same connexion it may, moreover, be noted that it would represent an unmistakable and valuable manifestation of the general desire for European co-operation, as well as a basis for efforts for the further improvement of conditions.

'The creation of a fund intended to facilitate the final abolition of exchange restrictions in certain countries which at the present moment transfer no more than a fraction of their foreign debts would be of the greatest importance to all creditors.

'It is this fact which would determine the general character of the fund and the rules which should govern its composition and operation.'[1]

It is clear that plans of this sort might be extended very considerably and are in fact a part of the big general problem of extending the resources of the B.I.S. so that they are of a magnitude sufficient to dominate a rapidly changing international monetary situation.

Thus, to sum up, from the technical point of view, it is probable that there are no major difficulties which would prevent a bank such as the B.I.S. from relieving very substantially an international financial crisis (as distinct from economic depression) provided that its resources were on an adequate scale and provided again that it was prepared to undertake operations which involved a certain amount of risk. This risk might be lessened if such Bank funds were given preferential treatment in the countries where they were employed. This would mean that the Bank funds would be exempt from seizure or restriction in time of War or emergency. Such a privileged position has already been granted to the Bank in many countries. Further, liquidity would not have to be an overriding consideration (or else in times of panic the Bank will be forced to follow the current rather than struggle against it) and the clause restricting operations to gold countries would have to be modified.

In so far as international *financial* crises are concerned, the pros-

[1] League of Nations: *Report by the Stresa Conference for the Economic Restoration of Eastern and Central Europe,* p.15.

pects of international financial co-operation are comparatively bright in the sense that machinery exists which could easily be developed should the nations of the world feel willing to do so.

5. *The World Credit Problem*

To many informed critics of existing monetary systems the most important part which a world bank such as the B.I.S. could play would be in connexion with the expansion or contraction of credit. That this question is of extreme importance must be admitted at once; in the ultimate resort it will be on it that any continuity of values will depend if we envisage a world system on however flexible a basis. If the world monetary system rests on a gold basis, this will be essential. There is no reason to suppose that new gold for monetary purposes will appear at exactly the same rate as economic developments would demand. The flow of new gold may be too small or may be too great, but it is unlikely to be exactly right for any lengthy period. Nor can we assume that the gold basis will not be affected by changes in people's habits, by hoarding or dis-hoarding, or through economies due, for example, to the wider use of cheques. The pressure on gold due to hoarding and the attempt to secure liquidity will vary from panic to panic and crisis to crisis, and the objective of any rational system would be to satisfy the demand with as little dislocation as possible. Under changing conditions credit policy must be elastic.

To what extent can the B.I.S. help by providing the opportunity for the creation or contraction of credit? Dr. Einzig maintains that the possibilities are almost unlimited, since the B.I.S. is restrained by no such limitations as the necessity of maintaining a ratio of cash to deposits, as are commercial banks.

'Even if the traditional ratio applied by the commercial banks—or possibly a more conservative figure—is observed, this does not prevent it from expanding credit to a very great extent. Its cash supply necessarily includes its balances with Central Banks, which constitute a very considerable proportion of its assets. Its liquid assets also include, however—according to the statutes—all its holdings of short-term bills, &c.: in one word, almost every asset they are entitled to hold. This means that the increase of its deposits brought about by the granting of fresh advances also increases its liquid assets almost to the same extent, and this, in turn, would enable the Bank to grant fresh advances by a multiple of the increase. The potential lending capacity of the Bank would thus tend to increase in geometric progression. The process has all the characteristics of an avalanche, unless checked in time by inherently sound management and conservative principles.

'It may be objected that the Bank would only grant advances on good security. But a Central Bank would find it easy to provide security that satisfies the Bank. It holds large amounts of genuine first-class commercial bills which would pass for good security, especially if the Central Bank endorses them. . . . any Central Bank would be able to increase its note circulation almost indefinitely by obtaining an advance from the Bank, depositing with it the securities acquired with the aid of the foreign currency thus obtained, raising on the security another advance, and repeating this process *ad infinitum*.'[1]

Mr. P. Barrett Whale has examined these arguments at some length[2] and has advanced the discussion a great deal farther. He points out that it is all a matter of hypothesis. On the hypothesis that all Central Banks agree to recognize all their B.I.S. holdings as reserves, Dr. Einzig is right and the possibilities of expansion tremendous. But this hypothesis has not been realized and is not likely to be realized. On the hypothesis that no Central Banks allow B.I.S. holdings to count for reserve purposes, there can be no increase in the total volume of credit, and there may even be a diminution in so far as credit is diverted from recognized reserves to B.I.S. deposits. Mr. Whale then goes on to consider an intermediate case in which a proportion of B.I.S. deposits are allowed to count as reserves, and shows that in this case there would be possibilities of expansion limited by the actual circumstances and by variations in conditions governing different Central Banks. This hypothesis appears to come nearest to real life; there is a possibility of credit expansion, but it is strictly limited.

Dr. Eleanor Dulles[3] discusses these points and tries to relate them to existing conditions. She concludes that 'On the one hand the Statutes, by direct and indirect statements of what the Bank may do, excluded the easier and more profitable methods of inflation. On the other hand, the management and Board, by the policies which they developed, made any expansion of purchasing power through the Bank unlikely.' She quotes the view of Professor Salin, who emphasizes 'the passive nature of the Bank and the difficulty it would have in retaining deposits if either political or economic factors should start an adverse movement'. She comments, 'There is little doubt that his argument is sound if his premise is granted, for the Bank is indeed helpless unless it has the real support of Central Banks.

[1] Einzig, *The Bank for International Settlements*, pp. 76–8.

[2] 'Notes on the International Bank and the Creation of Credit', in *Economica*, June 1930.

[3] Dulles, *The Bank for International Settlements at Work*, p. 176.

This support must be based on an enlightened self-interest that can be expected to stand severe shocks.'

It seems quite clear that there is practically no possibility of any substantial credit expansion under the auspices of the B.I.S. except with the consent and collaboration of the Central Banks. On the other hand, were the Central Banks to decide that world-credit expansion was necessary they could use the B.I.S. as a very efficient means to this end as long as a substantial proportion of B.I.S. deposits were allowed to rank as reserves with the Central Bank.

A World Central Bank which could prevent competition between local centres, each of which is attempting desperately to improve its own position as regards liquidity, would obviously have very great uses in time of panic. It could do this by increasing the amount of credit (whether built on a given amount of gold or not). It has been suggested that if the basic quantity of gold is insufficient 'an international note issue'[1] would be of use to swell the world's supply of gold. It is quite clear that given a willingness on the part of the nations of the world to make use of the opportunity offered by the B.I.S., there should be no difficulty about introducing this element of flexibility.

Yet the test of credit control cannot be formulated in terms of possibility of expansion alone. For the time being it seems not unlikely that with prosperity the problem will be to contract credit rather than to expand it—or rather, to prevent it expanding as rapidly as existing Central Bank regulations comfortably allow. The problem of a boom is only secondarily that of the amount of credit outstanding; primarily it is one of increased velocities. Under existing conditions the B.I.S. could do little to control the position, which would depend on the main on the policies followed by Central Banks themselves. Put in another way, the argument runs: the B.I.S. might do much to support Central Banks when there is a run on them during a financial crisis, but it is neither possible nor desirable that it shall seek directly to control the tempo of economic activity in the world at large. This control, if it is to be effective, must be undertaken by the stronger Central Banks acting in collaboration.

These and other reasons suggest that as far as credit control is concerned the B.I.S. must be a co-ordinating and persuasive agency and not a controlling agency. It will be the servant of Central Banks providing facilities and support. The balance of financial power must remain with the big Central Banks, and it will be for the B.I.S. to try to influence them in such a way that they use their power in a rational manner.

[1] Keynes, *The Means to Prosperity*, p. 30.

6. *An International Tribunal*

Any observer of recent international events could not fail to be impressed by the number of disputes arising, but over the question of what is a just and fair settlement in regard to debts, debtor and creditor seldom see eye to eye on the subject of 'capacity to pay'. This is not a question of law. It may be assumed that the legal rights are not in doubt; the question is one of what is possible and desirable. Thus The Hague Tribunal would not meet the case. The need is for some sort of international tribunal which can deal with outstanding financial disputes from an equitable standpoint, and which would command reasonable confidence in its disinterestedness and impartiality.

The usefulness of impartial arbitration is not confined to debt problems alone. One of the problems which has to be faced is the need of a change in the external value of a currency in the case of countries in special difficulties. There are many cases in which a change of parity might be of great service. This is especially so at a time when currency reconstruction must involve experiment before any suitable parities can be determined. And here a grave dilemma arises. The objections to what may be called 'unilateral changes of parity' are very great. They open the way to pressure by particular interests. They arouse suspicion in the minds of other countries. During periods of depression there is always temptation to put the parity below the equilibrium level in an attempt to capture an enlarged share of the world trade. All these considerations go to suggest that a change of parity by a country acting on its own initiative induces considerable dangers.

Yet the alternative of completely rigid parities is equally unsatisfactory. Experience has taught us that the necessary readjustments are not easy to make. They are never likely to be easy. An unjustifiable parity will only create unhealthy conditions. Unchangeable parities, which can only be altered by collapse or maintained through exchange restrictions, are as undesirable in the long run as parities which can be changed at will by any Government that is in power.

That parities should be changed under the auspices of an international tribunal of the sort suggested would seem to be one way out of the difficulty. It is true that in the last resort a sovereign state must always retain the right of determining the value of its own currency, but this could not prevent the offer of more advantageous facilities on the world capital markets to such states as altered the external value of their currencies only in accordance with the views of the tribunal.

Whatever the form an international tribunal of this sort might take, it would certainly serve a useful purpose in settling disputes which would otherwise involve delay and ill-feeling.

7. *The International Organization of Long-term Lending*

'Reconstruction' lending raises very difficult problems. Even if past debts have been written down to a reasonable level, a country that is in difficulties will not find it easy to borrow at manageable rates of interest. In the long run private lenders will come to her assistance, but as a rule the first step will have to be taken through some sort of collective action on the part of other countries, and there is no satisfactory machinery for such collective action.

Clearly the B.I.S. as a bank can play no direct part in the provision of long-term capital, and the problem becomes one of devising institutions of an entirely different kind for the purpose.

An example of such a body may be found in the International Agriculture Mortgage Credit Company, the Charter and Statutes of which were approved by the Council of the League of Nations and signed on May 21st, 1931.

'It is proposed that, under the terms of this convention, an International Agricultural Mortgage Credit Company should be founded, the objects of which should be:

1. To make long-term loans with amortization, or medium-term loans with or without amortization, to mortgage or agricultural credit companies or institutions which, either directly or through other companies having their registered offices in the same country, make loans upon first mortgages on immovable property which is the subject of agricultural cultivation or used for the purposes of such cultivation.
2. To create and negotiate bonds the sums repayable on which may not exceed the amount of the debts due from the national companies to the International Company and secured by first mortgages registered in the name of the national companies belonging to them or held by them as security.

'Such a company, with the special support of the contracting States and endowed with certain privileges indicated below, might, it is believed, issue bonds and thus secure funds on its own credit at a cheaper rate than could the national agricultural mortgage institutes of the countries in which it is hoped it may be able to do business.

'Of these privileges, the most important is that the company should, at the moment of its foundation, be endowed by means of Government advances by contracting States, with a special fund which should give an additional security to the holders of the bonds to be issued.

'It should be made clear that these contributions which it is suggested Governments should make are definitely in the nature of advances. Under the Statutes as drafted, machinery has been created for the purpose of ensuring a return on and the repayment of these advances.'[1]

It is unnecessary to describe the organization in detail, but it is interesting to recall the reason which promoted this development. The Financial Committee, in their Second Report to the Council of the League, quote the view expressed at a meeting of the Sub-Committee on Agricultural Credit,

'that lack of capital was one of the major factors which prevented the agriculturist from changing from those crops of which there was at present an excess to those the consumption of which was tending to increase. Moreover, all measures aimed at raising the standard of living in those European countries where the standard is at present relatively low must help to increase the demand for the higher-value agricultural products, such as meat, milk, fruit, &c. The granting of credit, and more especially the granting of credit where rates of interest are now abnormally high, would therefore help, on the one hand, to bring about those changes in production and, on the other, that increase in demand which are alike necessary for a general improvement in agricultural conditions. They would also certainly have the effect of increasing the purchasing power of agriculturists, and particularly their demand for industrial products.'[2]

But as yet nothing has been done to implement this proposal, and there is no sign that anything is being done.

While it is difficult to say, since the experiment has not been carried out, how valuable it may prove, it yet remains not unfair to conclude that the possibilities are considerable. It may be that any solution of the problem of collective international lending will follow lines not dissimilar to those of the proposal for this agricultural credit company.

[1] League of Nations, *International Agricultural Mortgage Credit Company* (Convention, Character, and Statutes), C. 375, M. 155, 1931, II. A, p. 9.

[2] Op. cit., p. 8.

CHAPTER XVII

MONETARY POLICY AND THE METALLIC BASIS

WHATEVER the form that monetary systems may take in the future, a necessary preliminary to any discussion of the prospects must be an examination of the possibilities of using gold and of the influences that the supply of new gold may exercise on economic conditions. Some years ago the fear was often expressed that the supply of gold available for monetary purposes would not be sufficient to keep pace with the demand for it. This, it was argued, would have a depressing effect on economic activity. The Gold Delegation of the League of Nations was set up to examine the problem, and, while unconvinced that a shortage of gold was as yet exercising any influence, they foreshadowed a time in the near future when such a shortage might make itself felt. Accordingly, it is necessary to examine this possibility in the light of subsequent happenings, and to assess its bearing on the international monetary problem.

1. *The Estimates of Cassel and Kitchin*

The world's need of gold has been discussed at considerable length by two distinguished authorities,[1] Professor Gustav Cassel and the late Joseph Kitchin, and they both have arrived at the conclusion that world stability, other things being equal, would involve an annual increase of 3 per cent. cumulative in the world supply of gold. Their estimates follow different lines, though they are both based on the period 1850–1910. While Cassel concerns himself with the augmentation of the world's total gold supply, Kitchin examines the increase in the world's supply of monetary gold.

Cassel estimates that the total gold supply was equivalent to £490,000,000 in 1850. By 1910 this had risen to £2,545,000,000. Making an allowance, possibly rather high, for wear and tear, Cassel calculates that this is equal to a cumulative growth of 2·8 per cent. per annum. He points out that the general level of wholesale prices was the same in 1850 and 1910, and suggests that had the increase in gold supply gone on steadily during this period, increasing at 2·8 per cent. instead of increasing spasmodically, the flow of new gold would have been eliminated as a disturbing factor.

[1] See Annexes X and XI of the *Interim Report* of the Gold Delegation (Geneva, 1930). See also Cassel, *Theory of Social Economy* and *The International Gold Problem* (Oxford University Press, for the Royal Institute of International Affairs), pp. 56 *et seq.*

He finds confirmation for his argument in an analysis of the rate of economic progress.

'Independent investigations of the rate of economic progress of countries of European civilization point in the direction that a rate of progress of about 3 per cent. per year may be regarded as characteristic for the period in question: for the United States, the rate, of course, must be put considerably higher. An approximate idea of the world's rate of progress may be gained in the following way. In the period 1850–1907, the world's production of pig-iron increased on an average by 4·2 per cent. Now, the growth of the iron industry may be regarded as characteristic of the whole industrial development of the world. The agricultural development has of course been much slower and may perhaps be put at the figure of 1·2 per cent. per year, which seems to correspond fairly well to the growth of the population and the improvement of its nourishment. If we assume that food represents a third of social income and that the other two-thirds of this income have grown proportionately to the industrial development, we arrive at an average rate of progress of 3·2 per cent. If, on the other hand, we give the rates for food and industrial production the same weight in our calculation of the average progress, this average would be 2·7 per cent. This figure ought to be regarded as the lower limit for our estimate of the world's average economic progress. As it seems necessary to give the industrial production a somewhat higher weight than the agricultural, we stand on fairly solid ground if we reckon with a figure of round 3 per cent. as characteristic of the economic development during the period 1850–1910'.[1]

Professor Cassel then goes on to examine the history of industrial fluctuation. In this he finds support for the view that, while the supply of gold has no effect on short-term cyclical fluctuations, it has definitely influenced the trend of prices. 'Our conclusion must therefore be that the secular variations in the general level of prices are mainly due to variations in the relative gold stock, and for the rest to certain irregularities in the normally uniform increase in the demand for gold.'

Turning to the future, Professor Cassel points out: 'If no further alterations are made in the monetary use of gold, the stability of the new price-level will depend on the possibility of such a production of gold as will keep pace with the general economic progress. If the rate of progress for the future is assumed to be the same as it was for the period 1850–1910, the stability of the present price-level will depend on the possibility of the annual gold production's amounting to 3 per cent. of the world's total stock of gold.'[2]

The late Joseph Kitchin, approaching the same subject from the

[1] *Interim Report*, p. 74.

[2] Op. cit., p. 75.

angle of the increase in monetary gold, reaches a very similar result. 'The conclusion is that, on the experience of 1850–1910, an average addition of 3·1 per cent. per annum to the world's stock of gold *money* was needed to keep commodity prices stable as far as their trend was concerned. Such an addition to that stock compares with the 2·8 per cent. (plus 0·2 per cent.) per annum of Professor Cassel, reckoned on the total stock of gold.'[1]

On these conclusions are based what might be described as a new malthusian doctrine, that economic activity will outrun the necessary gold supply because economic activity increases at compound interest while the gold supply may not even increase at simple interest failing the discovery of new sources of supply.

2. *The Significance of the Estimate*

Yet both these estimates are open to grave criticism. Cassel's estimate does not touch at all the question of how the gold supply is distributed between monetary and non-monetary uses. Kitchin does not allow for the fact that in 1850 silver was of especial importance as a monetary base, while in 1910 it was not. Further, neither seem to make adequate allowance for the development of credit methods during the period.

'The calculation that has been made, first by Professor Cassel and afterwards by Mr. Kitchin, as to the actual need for absorption of gold, is based on a period in both cases dating from somewhere about 1850, and ending somewhere about 1910. The period chosen seems to me to be such that it cannot possibly throw any light upon the need for monetary gold at all. In 1850 or thereabouts, there was one gold standard country in the world, namely, Great Britain. There was one bimetallic country in which gold predominated, namely, the United States. All Europe, apart from England, and I think the independent town of Bremen, used either silver or else the bimetallic standard in which silver predominated. Practically the entire currency for continental Europe, like the entire currency of Asia, was supplied without any gold at all—not literally without gold, because ever since the Middle Ages it has been the custom to use a certain amount of gold coin in Europe as a merchants' monetary medium. But the standard was silver, both in countries like Germany, Austria-Hungary, Russia, Norway, Sweden, Denmark, and Holland, where silver was the standard and where there was monometallism, and also in France, Belgium, and countries which were ostensibly bimetallic. Some of the countries I have mentioned were usually on a paper standard; but that does not affect my point, because the reserves were in silver. The period, therefore, in which the absorption of gold was averaging 3·1 per cent. of the monetary supply

[1] Op. cit., p. 80.

was one in which practically the whole commercially advanced world was transformed from a silver standard to a gold standard. Therefore, any demand for gold was something that had no relation whatever to the normal monetary growth at all. It is also the case that the same period saw a great development of credit instruments and credit organization, which would tend to economize gold to an enormous extent. What it amounts to is that of that period, on account of the last reason, you cannot say quite definitely that the absorption of gold was far above the normal during those sixty years; but you can say that if it was anywhere near normal it was purely fortuitous; that the effect of the quite abnormal demand for gold due to the putting of these countries on the gold standard was offset by the equally abnormal development of credit substitutes. For these reasons it seems to me that the 3·1 per cent. may not be a fair estimate here and now of the amount of gold that will be needed on suitable assumptions; but in order to discover what it is, you have to make assumptions first of all of the natural growth of note circulation, or any other factor that the gold reserve has to be related to; and, secondly, you have to make assumptions as to what the future relations of the note issue to the gold reserve are going to be.

'As the factors against which the higher per cent. increase of gold cancels out are completely unknown you are left with no result at all. You have two or three enormous forces at work, such as credit substitutes, growth of production, and change, whatever it was, in the proportion of people's resources in the form of money and credit. All those factors are completely unknown, and are pulling in different directions. All you know is that there is a relative correspondence of the price-level with the gold output. All it shows is that all these forces other than the gold output did more or less cancel out; but you are left completely in the dark about what it was that you are cancelling gold out against. You do not know what the situation would be if you eliminated this particular circumstance of the general passage on the gold standard. That would have been a radical change in the circumstances. You do not know how far conditions either as to economic expansion, or as to credit substitutes, or as to the habits of the people in regard to the amount of money and bank credits they hold in the future, will correspond to the past; so that you are left completely in the dark, so far as statistical guidance is concerned.'[1]

An attempt has been made to examine bank statistics to see what light they throw on monetary developments in relation to economic activity and the increase in the gold supply. Mr. J. T. Phinney has examined the statistics of the United States, Great Britain, France, and Germany without being able to establish any defined connexion.

'The conclusion of this analysis of bank statistics is that such data as are available show that little or no relation existed between the rate of

[1] R. G. Hawtrey in *The International Gold Problem*, pp. 75–6 and 79.

growth of the gold supply and the rate of growth of either bank reserves or bank notes and deposits. Between variations in gold production and variations in the rate of growth of the most important part of the circulating medium there seems to have been almost none of the correlation that is assumed by all studies of the problem of price trends that deal in terms of gold and prices alone. This absence of correlation is especially striking in the period from about 1875 to 1913, when so many of the statistics examined show a relatively constant rate of growth of bank reserves and of bank currency, quite unaffected by variations in gold production or by trends in prices.'[1]

Nor can one confine attention to the increase in the volume of credit and measures of this kind above. The velocity with which either currency or credit circulates may vary profoundly, and will vary with changes in habit as well as with more direct economic changes. Account must also be taken of the extent to which payments may be economized through changes in the structure of industry or through the possibility of debts being set off against each other. When all these factors are brought into consideration it is difficult to see how force can be put behind either Cassel's estimate or his conclusions.

Nor is it fair to argue purely in terms of the past. There is no particular reason why, assuming for the sake of argument that 3 per cent. cumulative was the appropriate rate for the period 1850 to 1910, it should be the appropriate rate for, say, 1930 to 1990. It may be too much, or it may be too low. 'What we are aiming at', Mr. Hawtrey reminds us, 'is to prevent not merely a world scarcity of gold, but also a world redundancy of gold. For that purpose you want to be prepared both to economize gold, if necessary, and also to absorb gold if necessary. These measures are just as necessary if you prove that the normal absorption of gold is only ½ per cent. per annum as if you prove that it is 4 per cent. per annum. In either case you have to be prepared to shield the monetary systems of the world from being disturbed owing to quite fortuitous changes in the supply of gold.'[2]

3. *The Possibilities of Gold Shortage or Excess*

There is no possibility of judging what the position in regard to the supply of monetary gold is likely to be either in the near or the more remote future. Ignoring new production, the factors making for an increasing effective supply of monetary gold are several.

[1] J. T. Phinney, 'Gold Production and the Price Level', *Quarterly Journal of Economics*, 1933, p. 677.

[2] Op. cit., p. 76.

First, the devaluations of currencies in terms of gold will very effectively increase the effectiveness of gold-backing once gold stock in Central Banks are revalued to conform with the changed position. This will not affect the 'gold bloc' countries, but it will mean an increase of 50 per cent. or more in the nominal value of the gold reserve in Britain, the United States, and other countries with depreciated currencies.[1]

Second, deliberate economies may be made in the use of gold within monetary systems. Thus it was recommended at the London Conference that 'in order to improve the working of a future gold standard greater elasticity should be given to Central Bank legal cover provisions; for instance, in so far as the system of percentage gold cover is applied a minimum ratio of not more than 25 per cent. should be considered as sufficient; similar elasticity should be achieved by appropriate measures where other systems are applied'.[2]

Third, gold hoarded in private hands may return to Central Banks as the situation becomes clearer. The B.I.S. comment: 'There are various ways of estimating the total amount of gold in private hands. Through a comparison of the results obtained by the different methods, it may be concluded that at the beginning of 1934 it was at least 7,000 million Swiss francs, or more than two and a half times the value of the current annual gold production. The existence of this "hidden reserve", some of which will become available when confidence returns, is of great importance in connexion with monetary reconstruction.'[3]

Fourth, there may be a greater economy in the use of cash through, for example, increased use of cheques. This is problematical, but the possibility cannot be left out of account.

Fifth, existing gold supplies may be made more effective through a redistribution of the enormous holdings of the lending countries, that is, of the United States, France, and—in a lesser degree—Great Britain. This also is problematical.

Against these factors making for a greater use of existing supplies must be set the undoubted fact that the Gold Exchange Standard—a powerful force making for the more intensive use of a given quantity of gold—is now looked on with distrust. However unfortunate it may be, it is natural that a stock of gold in a home Central Bank is considered safer than a balance with a centre abroad. The attempt to keep Central Bank reserves in the form of gold and not of foreign

[1] The nominal value of the gold reserve has already been written up in the United States. [2] Quoted in the *Fourth Annual Report of the B.I.S.*, p. 10.
[3] Op. cit., p. 22.

exchange holdings is bound to increase pressure on existing gold supplies.

There is the further possibility that the economic activities of the world will become such that a larger balance will be employed in the making of payments. Thus with increasing wealth, channels of trade may become more variable. If this happens, the monetary margin required to cover discrepancies as they arise from time to time—especially internationally—will become proportionately larger, and the demand for new gold all the greater.

When we turn to the supply of gold from the mines, the outlook is equally obscure. The Fourth Annual Report of the B.I.S. summarizes the recent history of gold production in the following table:[1]

Year.	*Union of South Africa.*	*U.S.A.*	*Canada.*	*Other producing countries.*	*Total for the world.*	*Millions of Swiss francs.*
	Thousands of ounces of fine gold.					
1915*	9,096	4,888	918	7,692	22,594	2,420
1923	9,149	2,503	1,233	4,901	17,786	1,905
1924	9,575	2,529	1,525	5,421	19,050	2,041
1925	9,598	2,412	1,736	5,285	19,031	2,039
1926	9,955	2,335	1,754	5,325	19,369	2,075
1927	10,122	2,197	1,853	5,274	19,446	2,083
1928	10,354	2,233	1,891	5,105	19,583	2,098
1929	10,412	2,208	1,928	5,037	19,585	2,098
1930	10,716	2,286	2,102	5,646	20,750	2,223
1931	10,878	2,396	2,694	6,238	22,206	2,379
1932	11,559	2,449	3,044	7,174	24,226	2,595
1933	11,012	2,537	2,938	8,233	24,720	2,648

* Record year before 1932 and 1933.

In 1930, when Kitchin and Cassel were making their estimates, it seemed probable that the output of the mines would decrease very soon. But this probability was completely upset by events, and the world output of gold has gone on increasing rapidly. This was due to the enhanced profits which could be secured in gold mining with gold at a premium of some 60 per cent. on previous currency values. These profits led to a burst of gold-mining activity first in Australia, then in Canada, and finally in South Africa. The gold output in 1933 exceeded that in 1932 in almost every gold-producing country except South Africa and Canada. In these two countries, where the gold-mining industry was the most highly developed and organized, the producers took advantage of the position to mine low-grade ore,

[1] Op. cit., p. 18.

which could not be worked profitably with gold at its standard price, reserving more high-grade ore. Thus, although the amount of ore crushed on the Rand was increased in 1933, the output of gold was reduced. The gold premium has tended to increase the production of gold, but continued increase will depend primarily on the currency price.

The stimulus of the high gold price has had a further effect in that it has led to intensive prospecting the world over. Several new areas are reported to have been found in Australia, and work is proceeding on the eastern and western extensions of the Rand, to say nothing of other parts of the Transvaal, Canada, and West Africa, but all these deposits are unproved and it will be years before their potential value is known. There is also the probability of an increasing gold output in the U.S.S.R.

Against these factors making for increase must be set the fact that in the long run, if the price of gold remains high, costs of production are bound to rise. How long this will take remains to be seen. The increased working of low-grade ore in preference to high-grade ore on the Rand suggests that producers there are to some extent prepared for this, and output will not be affected as drastically as might be expected if costs rise. Nevertheless, while it is impossible to dogmatize, we cannot be surprised if the present rate of gold output proves abnormally high in course of time. At least it is clear that the monetary systems of the world should not harness themselves to the rate at which new gold comes on the market.

4. *Silver*

The constant pressure in the United States on the Government to 'do something for silver' has thrown silver into the limelight. As more misconceptions centre around the question of silver than around almost any other question arising out of monetary policy, a few general remarks may not be out of place, although the matter falls largely outside the scope of this report.

The most common misconception is that which looks to a rise in the price of silver as improving the purchasing power of the peoples of the Far East. This is the exact reverse of the truth. In the case of a country on the silver standard, a rise in the price of silver means a fall in the price of goods: that is to say, a given quantity of silver exchanges for more goods. Thus a rise in the price of silver has a deflationary effect in the country using silver, though it is advantageous to a silver-producing country, which will get more goods in exchange for the mineral. China is not a silver-producing

country. A rise in the price of silver means that China is able to export less, that the balance of trade may be adverse, and that silver will leave the country (as gold leaves a country on the gold standard) as a signal that deflation is called for if China is to remain on the silver standard.

All these tendencies appear to be showing themselves, and may be illustrated by a message from the Shanghai Correspondent of *The Times*:[1]

'The silver policy of the United States Government is causing disquiet in China. What China needs is stabilization of the price of silver, and the main purpose of the international agreement signed last year was to bring that about. Contrary to the spirit at least of that agreement the United States Government in May adopted a bimetallic policy which involves the purchase of silver to an amount equivalent to about what the world produces in eight years. As a consequence the metal has risen steadily in price, with the result that since June Shanghai has exported silver to the value of about 60,000,000 Mexican dollars.

'Meanwhile the rise in silver tends to reduce the exports of China and accentuate the adverse balance which has been a feature of her trade figures during the past six years. If the process of selling silver on a large scale continues it may lead to an embargo or other restriction on the export of silver from this country. And if China went "off silver" as other countries have gone "off gold" she would have to adopt a managed currency, which is quite unsuitable for China in present circumstances.'

The stabilization of the price of silver at a reasonable level, bearing in mind the price structure of the silver-using countries and not only the desires of silver producers in Mexico or Nevada, is eminently desirable, and no doubt changes in the quantity of silver held for subsidiary purposes by monetary authorities could so be regulated as to prevent undue fluctuations in price.

The purchase of silver by the United States Government or monetary authorities increases the balances of the former holders of silver just as open-market operations increase the balances of former holders of securities. Parallel effects would occur if monetary authorities went even further afield. There is no intrinsic reason why monetary authorities should not operate on the commodity markets,[2] although such operations would be undesirable if they caused undue fluctuations in the prices of commodities.

So far the discussion has been based on the assumption that silver is kept in a purely subsidiary position. If we consider some form of

[1] *The Times*, 14 August 1934.

[2] Provided they are prepared to face losses, and can deal with the problem of storing commodities.

bimetallism or symmetallism, the consequences are much more important. Under a bimetallic standard monetary authorities are always prepared to buy and sell gold and silver at certain fixed prices. The demand will tend to concentrate itself on one or other of the metals, and the position may arise in which a country will be losing silver and receiving gold, or vice versa, the over-valued metal tending to drive out the under-valued. Such difficulties are likely to make the task of maintaining continuity of values unnecessarily difficult.

A symmetallic standard is not open to this objection. Under such a standard Central Banks would not receive or pay out gold or silver alone, but only quantities of metal composed of gold and silver in certain fixed proportions. This theoretically is as workable as the gold standard, provided it is universally adopted. But this last proviso makes the whole subject somewhat academic.

CHAPTER XVIII

ASPECTS OF MONETARY RECONSTRUCTION

It may be well to bring together some of the implications which emerge from the discussion in the previous pages, and to put into relief their significance in the light of existing circumstances.

1. *Currency and Management*

The phrase 'automatic' has sometimes been applied to the working of currency systems limited to gold. Such a phrase is dangerous because of the implied suggestion that monetary authorities are relieved from further responsibility as long as they see that a given set of reactions is always provoked by certain events. The whole case for an 'automatic' currency system appears to rest on the assumption that it reduces the responsibilities of those working it. This is untrue. No currency system which involves the use of credit has been, or will be, 'automatic' in any but the most superficial sense; the only relevant differences are between well and badly managed currency systems, and again between currency systems more or less international in character.

The word 'automatic' is applied chiefly with reference to the gold standard in the past. Inflows or outflows of gold provoked a given reaction and that, apparently, was the end of the matter. But this is only very superficially the case. It is true that the normal response to gold movements did help to keep currencies in line with each other, but it did not in any way control the general line of development in the world at large. It meant that if Bank Rate in the leading countries, particularly in Great Britain, was high, bank rates were high everywhere. There was no 'automatic' explanation of the level of bank rates in general. The monetary system of the world worked automatically only in the sense that one railway coach moves automatically because it is linked to the coach in front; the responsibilities of the engine-driver still remain.

And even a simile of this sort exaggerates the automatism. In any monetary system of the future the authorities will have the responsibility of distinguishing between different types of gold movements;[1] it will be vital, if monetary relations between countries are to be kept on a sound basis, for a distinction to be drawn between movements reflecting real economic changes and others reflecting purely financial

[1] Assuming gold. If we assume an international credit standard, the authorities would have to distinguish between different types of change in indebtedness.

changes. In addition, there is the very relevant consideration that gold movements may come too late, and may only show that disequilibrium has occurred without acting as warning-signals of dangers to come.

The problem, then, is one of intelligent management which will provide a unity of policy. There is no automatic substitute for this, and in the absence of such a unity any international standard is bound sooner or later to drift into disaster.

2. *Internal and External Stability*

Even under fairly settled conditions incompatibility between a reasonable continuity of values and stable exchanges may arise from several causes. The first might be described as the political factor: wars and rumours of wars, revolutions and rumours of revolutions, will in time break up any economic structure. On this point more need not be said. The second factor is the nature of the management itself. Effective currency management for the world at large, if it is to harmonize the two aims, will have to go far beyond the somewhat passive function of offering credit on appropriate terms. It will have to deal appropriately with movements of 'bad money'. It has been suggested that this is not in itself a particularly difficult problem, and it appears likely that, with increasing stability, the dimensions of the problem will be much smaller. There is the necessity of supporting countries which are suffering from temporary failure with short-term and middle-term credits. There is the further necessity for writing down past debts and providing new capital in the case of those countries which are dependent on industries made valueless through the operation of the forces of change. A third factor making for incompatibility may be found in the different rates at which productivity increases in various countries. How important this may prove is a question on which there are differences of opinion. Changes in productivity may be counterbalanced under certain conditions by changes in the terms of trade; many of the more spectacular examples of increasing productivity may be more apparent than real; increasing productivity may be counterbalanced by increasing wages. Nevertheless—when all is said and done—this source of disequilibrium must be allowed for. The degree to which external stability and an internal continuity of values remain compatible will depend on the way that these causes of disequilibrium are approached.

In the real world it is impossible to believe that such problems will be susceptible to complete solution for a long time to come. In the circumstances some variations of parity must be allowed for; the

opinions of members of the Group differ as to the circumstances in which variations would be justifiable.

3. *Credit Control in an International System*

No international monetary system can be satisfactory if it does not work effectively in times of crisis. Therefore it would perhaps be well to pause for a moment to ask the question, 'How should a monetary system react under conditions of strain?' In Great Britain, if there is a sudden demand for cash and free balances owing to an unexpected pressure for liquidity, a general liquidation is avoided because the Bank of England can be called upon to give support. It is true that the Bank does make a charge for this assistance in order to discourage people from availing themselves of it except under conditions of emergency, but the Bank is always ready to help if emergency does come. It is 'a lender of last resort', and is able to respond immediately, and so to enable the rest of the monetary system to respond to any sudden change. The exceptional success of the British banking system during years of difficulty is due to this element of elasticity in the structure. The banking structure is such that it is able to deal not merely with fair-weather conditions, but also with conditions of the gravest difficulty, in such a way as to permit of the minimum of disturbance.

In essence the world problem is the same. What is needed is a world lender of last resort who can satisfy the demand for liquidity in time of crisis. This is in essence a strictly technical problem which can be solved on the assumption that the strong financial powers are prepared to provide organized support in an emergency so that the world monetary structure becomes elastic and able to respond to the strain put upon it instead of being brittle and breaking into pieces. This elasticity could be imported into the world monetary system through the machinery of the Bank for International Settlements on three conditions—first, that the resources of the B.I.S. were increased; second, that Central Banks agreed that their deposits—or at least a large proportion of their deposits—with it should be allowed to count as reserves; and, third, that the restriction on the B.I.S. confining its dealings to gold currencies and enjoining special regard to liquidity were removed. Given these three conditions, and given also a reasonable amount of support by the leading Central Banks, there is reason to suppose that a large step would have been taken towards building up an international system workable under conditions of strain.

There is one qualification, however, which has been mentioned previously and which must be stressed again. The support necessary

in time of stress would have to go beyond anything that a bank alone can provide, or even ought to provide. A bank in theory should only give short-term, or at most medium-term, support. Adequate arrangements for the writing down of bad debts and for the provision of long-term lending through collective action, and on a more satisfactory basis than has been the case in the past, would be a necessary corollary. Any international system requires, not larger capital movements than have taken place in the past (probably they should be very much smaller), but much more consistent capital movements. Much less money should be lent during periods of prosperity, but, conversely, more should be lent during periods of difficulty, and it is on the world's capacity to organize such lending that the effectiveness of an international system must ultimately depend.

There is one further consideration which may be mentioned shortly. The significance of London in the past has been due to the fact that she has remained a world and not merely a national or an Imperial monetary centre. Since the last depression there has been a tendency to concentrate attention on Imperial rather than on international lending. This tendency has been a happy one in so far as lending within the Empire has on the whole proved a better risk than lending to foreign countries. But it is important to remember that if any restoration of a world system be envisaged, the flow of capital will have to be directed to those places where it is most needed and where it can most usefully be employed. It does not follow that these places will be situated within the bounds of the Empire, and it would only lead to grave dislocation in the system as a whole if the responsibilities of London as a world monetary centre were interpreted more narrowly in the future than they have been in the past. Taken as a whole, the Empire is probably fairly well supplied with capital, possibly even better supplied than Great Britain herself. But the places where both need and opportunity are likely to be greatest may well turn out to be in foreign countries. No international monetary system will work unless those opportunities are taken, and those needs are satisfied.

4. *The Use of Gold*

A great deal of controversy has centred on the use of gold for monetary purposes. It is often argued that its use is both illogical and unnecessary. Any rational examination of the question must admit these criticisms, though not necessarily some of the arguments which are based on them. It is illogical that for the purpose of organizing payments we have—as the process has been described

before now—to dig a yellow metal out of one hole in the ground in order to bury it again in another. The long and expensive process of transferring gold from mine to basement of Central Bank seems indeed unnecessary. The whole purpose of monetary systems is to exchange debts of different maturity against each other, and on rational grounds it would seem ridiculous that so extravagant a counter as gold had to be used in the process.

But however weak the case for the use of gold may seem in the light of rational analysis, it assumes a different complexion when we take into consideration, as indeed we must, that mankind is frequently irrational in its actions. Given the fact that people are irrational, and given the further fact that for some time to come they are likely to show a preference for gold, the question arises, Is it as easy to manage an effective monetary system with gold as it is without gold? Whatever the position in Great Britain, if we take the world into consideration, any attempt to dispense with gold would arouse difficulties.

Nor, if we are to admit only rational considerations, can we refuse to face a further very important fact. A world monetary system, fully organized on a non-gold basis and able to support necessary readjustments in countries which have specialized in the production of particular commodities, would be faced at the outset with the task of demobilizing the larger part of the South African gold industry and of providing South Africa with alternative forms of activity. If it fails to do this successfully it will be faced with economic disturbance, possibly of a major kind.

But the way in which gold is used is an important consideration. Its purpose should be for the making of international payments and not for the satisfying of demands for internal hoarding. If this is so, gold should be allowed to move freely, while changes in internal credit should be related not so much to the gold movements as to the nature of the purposes for which the gold is being allowed to move. A purely quantitative reaction is not enough; the quality of the movement must be judged. This follows from the discussion of the 'bad money' problem, and of the problem of temporary failure, throughout the preceding pages. The moral would appear to be that gold should not be used as a backing for notes—or at least, if some gold is so used, that there should be an adequate supply of free gold.

A further device might perhaps be considered with a view to preventing gold hoarding by the public. Central Banks might agree to receive and sell gold at fixed prices as before, but only on condition that this gold went to other Central Banks. They would then not

hand over the gold, but would send it direct to other Central Banks in accordance with the demand of those who wished it sent. Thus the gold would not be handled by those who transferred it, and the private gold-hoarder would be eliminated.

5. *Possible Outcomes*

These theoretical considerations have to be considered in the light of happenings in a real world whose behaviour is remote from the considerations of theory. The question is not, for example, one of alternatives between a large number of quite independent systems on the one hand and a perfect international system on the other. It is rather one of the extent to which some organization can be developed between existing countries and groups of countries which would provide an effective basis for economic activity and commercial intercourse. There are two forces at work. On the one hand, there is the force of economic internationalism, making for specialization on the widest possible basis and for the most rapid and widespread utilization of the world's resources. On the other, there is the force of nationalism, directed towards giving each individual country a measure of economic security so that it shall not be impoverished through a sudden change in the economic situation which leaves its main industries unemployed and its population destitute. Thus material advance and the desire for economic security are set off against each other. A country may find it worth while developing its agriculture at considerable expense in order to lessen its dependence on export industries which may fail. This clash between progress and security, between internationalism and nationalism in the economic sphere, is bound to condition any monetary arrangements which may be found practicable. It is most desirable that as far as possible arrangements should be on a world basis, but this possibility depends entirely on the assurance that can be given to individual countries that if they specialize they will not find themselves left stranded and bankrupt under the impact of economic change.

SUMMARY OF PART THREE

THE economic world of to-day can be examined from two aspects. From one point of view, it is a single economic unit which allows of specialization on an international basis, and provides the largest—and therefore most economic—markets. From another point of view it is composed of a mosaic of separate units, each with its own Government, its own monetary system, its own population, and its own indebtedness, which cannot be transferred. Corresponding to these two aspects are the two aims which monetary policy must seek to serve: on the one hand, to minimize disturbance in the terms on which the currencies of different national units exchange against each other, so that it is possible to gauge investment opportunities on a world basis and not merely on a narrow national basis; on the other, to preserve a reasonable continuity of values throughout the different national units. Neither the two aspects, nor the two aims, are completely contradictory one to another. The economic world is at the same time both national and international, and any projected monetary arrangements must recognize these facts. Only from a very narrow point of view are internal continuity of values and external stability a contradiction in terms; in fact, it is truer to say that they are complementary, since neither can be attained if the other is completely ignored. Monetary policy must seek to harmonize these two aims as far as possible.

The pre-War gold standard worked moderately well because the environment was more happy and because the dominating position of London provided a steadying influence. Gold preserved fixed exchanges, while the absence of any dislocation on the post-War scale enabled an approximate continuity of values to be maintained; though large oscillations in trade and production did in fact occur, they were not on a scale comparable to post-War experience. While the pre-War gold standard was the result of an increasing international relationship between prices and costs, the post-War standard was an attempt to restore such a relationship. The disequilibrium turned out to be too strong for it, especially as some of the parities chosen were completely out of relation to underlying conditions.

The difficulty of determining a true parity remains. Professor Cassel's attempt to define purchasing-power parity in terms of internal purchasing power in the respective countries depends on approximations and assumptions of 'other things being equal' which gravely vitiate results. Under conditions of change the value of

any calculations on his lines is limited. In these circumstances methods of trial and error must be adopted, careful watch being kept over the volume and nature of changes in foreign balances, and over internal conditions. Any changes of parity should only reflect real changes in underlying conditions.

Among the special problems which any effective world monetary system must face is that of securing harmonious working between the various national systems. Action and re-action are not always equal. In general, a payment by one country to another should involve a contraction in the one exactly balanced by an expansion in the receiving country, and any departures from this rule should be the result of design and not of accident. But financial structures differ in sensitiveness, and where the difference is substantial the dangers of real dislocation may under certain circumstances become great. Special provision will have to be made if such dangers are to be avoided.

Another technical problem which calls for attention is that of the effective handling of short-term balances moving from country to country at the will of their owners. These should be dealt with, in contrast to movements reflecting real economic changes, by a technique of offsetting, so that the disturbance is minimized. If this technique is effective, there should be no inflation or deflation or changes of parity, since there is no point in trying to retain 'bad money' against the will of the owners, or offering unreasonable rates for it.

The working of any international monetary system must depend on a reasonably consistent flow of international lending devoted to the building up of tangible assets. While criticism of post-War lending appears exaggerated when we examine statistics of British overseas investments, there is no doubt that much of it was unsatisfactory. Investments seem unduly to have taken the form of the purchase of fixed-interest Governmental obligations, and many of them seem to have been made without due regard to economic purposes.

If specialization on a world basis is to continue, provision will have to be made for countries which concentrate on particular products and which consequently are especially vulnerable with any change which substantially alters the demand for their exports. The technique will vary if the country is experiencing a temporary setback, or if it is suffering from permanent maladjustment. In the former case efforts should be concentrated on maintaining the existing position through short-term and medium-term lending; in the latter, on

the writing down of past debts and the provision of fresh capital in order to build up new compensatory forms of activity.

Most of the problems discussed above require some form of international machinery if they are to be dealt with in a satisfactory manner. The Bank for International Settlements provides the nucleus for such machinery, but it has been hampered in the past by certain restrictions, and in particular by the scantiness of the resources at its disposal. If the B.I.S. were to have larger resources at its disposal, if the restriction of its activities to gold-standard currencies were removed, and if it were placed in a position to immobilize a larger portion of its assets in time of financial crisis, many of the difficulties which have been discussed could be overcome. But the success it would have would depend on the support it enjoyed from Central Banks, and on their willingness to treat balances with the B.I.S. as reserves for statutory purposes. Further important developments would be an international tribunal to deal with financial questions on grounds of equity, and a machinery for collective long-term lending, possibly on the lines of the International Agricultural Mortgage Corporation.

The estimates of Cassel and Kitchin, arguing that a steady increase in gold of 3 per cent. per annum is necessary if the world is to avoid depression due to a gold shortage, are of doubtful validity. But we must be prepared to deal with either an excess or a shortage of gold. In Mr. Hawtrey's words, 'you want to be prepared both to economize gold, if necessary, and also to absorb gold if necessary'.

There is no such thing as an 'automatic' currency system; all currency systems are managed in one form or another, a fact which is not always faced. Theoretically, the possibilities of combining internal and external stability through management are much greater than is often supposed, but practical difficulties remain. It would be important to introduce an element of elasticity into any international system, in order to enable it to withstand strain. The possibility of working any international system will depend on how far it can provide for particular countries economic security against the impact of change.

* * *

In concluding this study the Group wish again to draw attention to the ground which they have sought to cover. In Part One they have set out shortly their views on the practical issues of monetary policy as it affects the world at the present time. In Parts Two and Three they have provided a more detailed analysis of the various

questions involved, dealing in the former Part with the domestic and in the latter with the international aspects of the monetary problem. They have thus aimed at providing a background of established fact and of current theory for those readers who desire to follow in some detail the points at issue in regard to a highly controversial subject.

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